SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

CLAY B. BROWN, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Nos. 18228—18233

United States Court of Appeals

for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILIP F. BROWN, MARILYN BROWN,
Respondents.

Transcript of Record

Petition to Review a Decision of the Tax Court of the United States

NAMES AND ADDRESSES OF ATTORNEYS

LOUIS J. OBERDORFER,
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Washington 25, D. C.

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WILLIAM H. KINSEY,
Board of Trade Building,
Portland 4, Oregon.

Attorneys for Respondents.

The Tax Court of the United States

Docket No. 83795

CLAY B. BROWN and DOROTHY E. BROWN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION

The above-named petitioners hereby petition for redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency (Ap:P:AA:HH-90D:MAC) dated July 30, 1959, and as a basis for their petition allege as follows:

1. The petitioners are husband and wife residing in Portland, Oregon. During the periods herein involved petitioners filed joint income tax returns with the District Director of Internal Revenue for the District of Oregon.

2. The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to the petitioners on July 30, 1959.

3. The deficiencies as determined by the Commissioner are for income taxes for the below indicated calendar years in the below specified amounts:

Taxable Year Ended	Deficiency
December 31, 1953	$ 2,732.62
December 31, 1954	5,073.80
December 31, 1955	50,779.14
Total	$58,585.56

Substantially all of the above deficiencies are in dispute.

4. The determination of income tax set forth in said notice of deficiency is based upon the erroneous determination that the gain reported by petitioners from the sale of their stock in Clay Brown & Company, an Oregon corporation, constituted ordinary income rather than long term capital gain.

5. The facts upon which the petitioners rely as the basis of this case are as follows:

(a) On September 30, 1946 petitioners each acquired 6000 shares of the common stock of Clay Brown & Company at a cost of $1.00 per share, making a total of 12,000 shares having an aggregate cost of $12,000.00.

(b) Petitioners held said 12,000 shares of stock from the date of acquisition until February 1953.

(c) Said shares of stock were not held by petitioners for sale to customers in the ordinary course of business, or in any other manner which would preclude such shares from qualifying as a capital asset.

(d) In February 1953, petitioners sold said 12,000 shares to California Institute for Cancer Research under a written purchase agreement dated February 4, 1953 for the sum of $440,625.00 payable as provided in the purchase agreement.

(e) The gain realizable by petitioners upon such sale of the 12,000 shares was $414,000.00, being the $440,625.00 purchase price less the cost basis

of $12,000.00 and less expenses of sale in the amount of $14,625.00.

(f) In their income tax returns for the subject years petitioners reported on the installment basis the following amounts as long term capital gain:

Year	Gain
1953	$ 4,121.87
1954	16,688.28
1955	111,511.28

Such amounts are portions of the purchase price received during the indicated years reportable on the installment basis.

(g) The 12,000 shares of stock in Clay Brown & Company were capital assets held by petitioners for more than six months, and the gain identified in subparagraph (f) above constituted proceeds from the sale of such capital assets entitled to long term capital gain treatment.

Wherefore, the petitioners pray that this Court may hear the proceeding and determine that the deficiencies due from petitioners for the years 1953, 1954 and 1955 do not exceed the comparatively small amounts resulting from the proposed adjustments other than the adjustment asserted as erroneous in this petition.

/s/ WILLIAM H. KINSEY,
Tenth Floor Board of Trade Building,
Portland 4, Oregon

[Duly Verified]

Exhibit A

Letterhead of
U. S. Treasury Department
Internal Revenue Service
Office of Regional Commissioner

Registered Mail

July 30, 1959

Ap:P:AA:HH-90D:MAC
425 Pittock Block
921 S. W. Washington Street
Portland 5, Oregon

Taxable Year Ended	Deficiency
December 31, 1953	$ 2,732.62
December 31, 1954	5,073.80
Total	$58,585.56
December 31, 1955	50,779.14

Mr. Clay B. Brown
Mrs. Dorothy E. Brown
1000 S.W. Vista Avenue
Portland, Oregon

Dear Mr. and Mrs. Brown:

The determination of your income tax liability for the above taxable year(s) discloses a deficiency or deficiencies in the amount(s) shown above and in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court

of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency or deficiencies. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you desire to file a petition, you are requested to execute the enclosed agreement form (Form 870) and forward it to the above address. Please cite the reference shown at the top right of this letter. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earliest.

Very truly yours,
Dana Latham
Commissioner
By (Signed) A. N. WILLIAMS
Associate Chief,
Appellate Division
Division

Enclosures:
Statement
Pub. #160
Agreement form (Form 870)
MACascaden 1a

Statement

Taxpayers: Clay B. and Doroty E. Brown
1000 S. W. Vista Avenue
Portland, Oregon
(formerly: 01962 S. W. Military Road)

Income tax liability for the taxable years ended December 31, 1953, December 31, 1954 and December 31, 1955.

Year	Tax Deficiency
1953	$ 2,732.62
1954	5,073.80
1955	50,779.14
	$58,585.56

In making this determination of your tax liability careful consideration has been given to the report of examination transmitted to you December 17, 1957, to your protest received February 6, 1958, and September 9, 1958, March 30, 1959 and April 17, 1959.

A copy of this letter and statement has been mailed to your representative, Mr. William H. Kinsey, Board of Trade Building, Portland 4, Oregon, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1953

Adjustments to Net Income

Net income disclosed by return		$50,880.12
Unallowable deduction and additional income		
(a) Other compensation	$ 691.90	
(b) Dividends	562.81	
(c) Partnership income—auto depreciation	307.09	
(d) Other income	4,116.28	
Total	5,678.08	
Nontaxable income and additional deductions:		
(e) Capital gain	2,060.94	
Total adjustment increase		3,617.14
Net income as adjusted		$64,497.26

Taxable Year Ended December 31, 1953

Explanation of Adjustments

(a) During the year 1953 the corporation Fortuna Sawmills, Inc., of which Clay Brown was the general manager, paid certain social club dues and expenses for his personal benefit, as follows:

Arlington Club dues	$243.00
Waverly Club dues and expenses	448.90
Total	$691.90

It is held that said expenditures constitute additional compensation to be treated as ordinary income to Clay Brown. Accordingly, ordinary net income has been increased by the amount of $691.90.

(b) During the year 1953 the corporation Clay Brown & Company paid legal fees and appraisal fees in the respective amounts of $1,250.00 and $250.82, or $1,500.82 in all, solely for the benefit of the stockholders.

It is held that said expenditures represented the distribution of taxable dividend income, constructively received in the hands of the stockholders. You owned 12,000 shares of stock out of 32,000 shares outstanding. Your proportionate share is, therefore, 12/32nds of $1,500.82 or $562.81. Accordingly, ordinary net income has been increased by the amount of $562.81.

(c) Adjustment is made for depreciation on your personal automobiles which was claimed as an item of expense on the partnership return of Brown Timber & Investment Co. Computation is as follows:

*Buick 1953 4-dr Sedan 2/13/53 (4 yrs.) $3,104.24 =	$258.68
*Chevrolet 1953 2-dr Sedan 4/20/53 (4 yrs.) $2,323.65 =	48.41
*Part of year	$307.09

(d) and (e) On your return as filed you reported long term capital gain as from the sale of all of your stock in Clay Brown & Company, on the installment plan, in the amount of $4,121.87, of which one-half, or $2,060.94 was taken into account.

It is held that the transactions involved gave rise to ordinary income under Section 22(a) of the Internal Revenue Code of 1939, and that the taxable income therefrom for the year 1953 is in the amount of $4,116.28. (See Schedule I attached hereto for explanation of the difference between $4,121.87 and $4,116.28).

Accordingly, ordinary net income has been increased by the amount of $4,116.28, and long term capital gain taken into account as reported has been decreased by the amount of $2,060.94.

Computation of Tax — 1953
(Alternative Method)

Net income as adjusted	$64,497.26
Less: Exemptions 2x$600	1,200.00
Taxable income	63,297.26
Enter one-half—joint return	31,648.63
Less: 50% of net long term capital gain—if joint return, enter one-half	1,270.27
Balance subject to normal tax and surtax	$30,378.38
Partial tax	14,929.51
Times two—joint return	29,859.02
Add: Net long term capital gain—104% of amount shown above	1,321.06
Tax liability	$31,180.08
Self employment tax—Dorothy E. Brown	81.00
Total tax liability	31,261.08
Liability disclosed by return, Account No. AF 1000565	28,528.46
Deficiency	$2,732.62

Taxable Year Ended December 31, 1954
Adjustments to Net Income

Net income disclosed by return		$42,529.62
Unallowable deduction and additional income		
(a) Other compensation	$ 270.75	
(b) Other income	16,664.21	
Total	16,934.96	
Nontaxable income and additional deductions:		
(c) Capital gains	8,344.14	
Total adjustment increase		8,590.82
Net income as adjusted		$51,120.44

Taxable Year Ended December 31, 1954
Explanation of Adjustments

(a) During the year 1954 the corporation Fortuna Sawmills, Inc., of which Clay Brown was the general manager, paid certain social club dues and expenses for his personal benefit, as follows:

Arlington Club dues	$114.00
Waverley Club dues and expenses	156.75
Total	$270.75

It is held that said expenditures constitute additional compensation to be treated as ordinary income to Clay Brown. Accordingly, ordinary net income has been increased by the amount of $270.75.

(b) and (c) On your return as filed you reported long term capital gain as from the sale of all of your stock in Clay Brown & Company, on the installment plan, in the amount of $16,688.28, of which one-half, or $8,344.14 was taken into account.

It is held that the transactions involved gave rise to ordinary income under Section 61 (a) of the Internal Revenue Code of 1954, and that the taxable income therefrom for the year 1954 is in the amount of $16,664.21. (See Schedule I attached hereto for explanation of the difference between $16,688.28 and $16,664.21).

Accordingly, ordinary net income has been increased by the amount of $16,664.21, and long term capital gain taken into account as reported has been decreased by the amount of $8,344.14.

Computation of Tax—1954

Net income as adjusted	$51,120.44
Less: Exemptions 4 x $600	2,400.00
Taxable income	48,720.44
Enter one-half—joint return	$24,360.22
Tax	9,772.53
Tax liability—times two—joint return	19,545.06
Liability disclosed by return, Account No. BC783	14,471.26
Deficiency	$5,073.80

Taxable Year Ended December 31, 1955

Adjustments to Net Income

Net income disclosed by return	$ 96,943.50
Unallowable deduction and additional income (a) Other income	111,359.85
Total	$208,303.35
Nontaxable income and additional deductions:	
(b) Capital gains	55,755.64
Net income as adjusted	$152,547.71

Explanation of Adjustments

(a) and (b) On your return as filed you reported long term capital gain as from the sale of all of your stock in Clay Brown & Company, on the installment plan, in the amount of $111,511.28, of which one-half, or $55,755.64 was taken into account.

It is held that the transactions involved gave rise to ordinary income under Section 61(a) of the Internal Revenue Code of 1954, and that the taxable income therefrom for the year 1955 is in the amount of $111,359.85. (See Schedule I attached hereto for explanation of the difference between $111,511.28 and $111,359.85)

Accordingly, ordinary net income has been increased by the amount of $111,359.85 and long term capital gain taken into account as reported has been decreased by the amount of $55,755.64.

Computation of Tax—1955

Net income as adjusted	$152,547.71
Less: Exemptions 4 x $600	2,400.00
Taxable income	$150,147.71
Tax liability	92,459.65
Liability disclosed by return, Account No. EF 2539	41,680.51
Deficiency	$ 50,779.14

SCHEDULE I

	Per Returns Filed		Corrected	
Total amount to be received		$440,625.00		$440,625.00
Less:				
Basis claimed	$ 12,000.00		$ 12,000.00	
Expense attributable to transaction	14,625.00		14,625.00	
Legal & appraisal expense	—		562.81	
		26,625.00		27,187.81
Total net gain		414,000.00		413,437.19
Percent of gain to total amount to be received		93.9574%		93.83%
Year 1953:				
Amount received in 1953	4,386.96		4,386.96	
Portion thereof representing gain, per above percentage factors		$ 4,121.87		$ 4,116.28
Year 1954:				
Amount received in 1954	18,893.08		18,893.08	
Portion thereof representing gain, per above percentage factors		17,751.45		17,727.38
Less Additional expenses attributable to transaction, paid in 1954		1,063.17		1,063.17
Net gain, year 1954		$ 16,688.28		$ 16,664.21
Year 1955:				
Amount received in 1955	118,862.14		118,862.14	
Portion thereof representing gain, per above percentage factors		111,679.78		111,528.35
Less additional expenses attributable to transaction, paid in 1955		168.50		168.50
Net gain, year 1955		$111,511.28		$111,359.85

[Representative of all Petitions.]

Received and Filed Oct. 26, 1959.

Served Oct. 26, 1959.

[Title of Tax Court and Cause.]

ANSWER

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. Admits the allegations in paragraph 1 of the petition.

2. Admits the allegations in paragraph 2 of the petition.

3. Admits the allegations in paragraph 3 of the petition.

4. Denies the allegations of error contained in paragraph 4 of the petition.

5. Denies the allegations contained in paragraph 5 of the petition and all subparagraphs thereof.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ HART H. SPIEGEL,
Chief Counsel,
Internal Revenue Service.

Of Counsel:
CHARLES W. NYQUIST,
Acting Regional Counsel,
LEO K. O'BRIEN,
Attorney,
Internal Revenue Service,
484 Pittock Block,
Portland 5, Oregon

[Representative of all Answers.]

Received and Filed Dec. 18, 1959.
Served Dec. 22, 1959.

37 T. C. No. 50

Tax Court of the United States

Docket Nos. 83795, 83796, 83797, 83798, 83799, 83800.
Filed December 19, 1961.

CLAY B. BROWN and DOROTHY E. BROWN,[1]
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

FINDINGS, CONCLUSIONS AND OPINION OF TAX COURT

Petitioners transferred their stock in a corporate enterprise, along with two primissory notes totaling $125,000, to I, a tax-exempt organization, in consideration for a non-interest-bearing note in the amount of $1,300,000. I was obligated to pay petitioners 90 percent of the income it received from a lease of the corporate assets in payment on the note but was not otherwise bound to make payment. I liquidated the corporation, sold its current assets subject to liabilities

---

[1]Proceedings of the following petitioners are consolidated herewith: Donald L. Brown and Ingrid R. Brown, Docket No. 83796; Charles William Booth and Nancy H. Booth, Docket No. 83797; Donald Lee Brown, Docket No. 83798; Philip F. Brown, Docket No. 83799; and Marilyn Brown, Docket No. 83800.

(other than the $125,000 of notes) and leased the fixed assets for a period of 5 years to a new corporation, F, which had been set up by a third party separate from petitioners. F was obligated to pay rent equal to 80 percent of its net profits before taxes and depreciation. At the termination of the 5-year lease the corporate assets were returned to I, which entered into an amended agreement with petitioners permitting it to negotiate a sale thereof even though the $1,300,000 note was not paid in full. The assets were subsequently sold by I to the State of California for $300,000, thus terminating the transaction between petitioners and I. Held, the transfer of petitioners' stock to I in return for the promissory note constituted the sale of a capital asset. Held, further, no part of the amounts received by petitioners is allocable to interest.

William H. Kinsey, Esq., and James R. Moore, Esq., for the petitioners.*

Norman H. McNeil, Esq., and Aaron S. Resnick, Esq., for the respondent.

Scott, Judge: Respondent determined deficiencies in petitioners' income taxes for the years and in the amounts as follows:

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*Brief amicus curiae was filed by Arthur A. Armstrong as attorney for the West Los Angeles Institute for Cancer Research.

Docket Number	Petitioner	Taxable Year	Deficiency
83795	Clay B. Brown and Dorothy E. Brown	1953	$ 2,732.62
		1954	5,073.80
		1955	50,779.14
83796	Donald L. Brown and Ingrid R. Brown	1954	2,080.04
		1955	16,621.28
		1956	5,815.76
83797	Charles William Booth and Nancy H. Booth	1953	79.74
		1954	231.66
		1955	2,005.41
		1956	840.97
83798	Donald Lee Brown	1953	1,445.28
83799	Philip F. Brown	1953	260.00
		1954	1,042.61
		1955	18,462.71
		1956	6,639.80
83800	Marilyn Brown	1953	260.00
		1954	1,003.39
		1955	18,465.66
		1956	6,590.81

The principal issue for decision is whether the gain realized by petitioners upon the disposition of their stock in Clay Brown & Company is long-term capital gain from the sale of such stock as reported by petitioners or ordinary income from a transaction which does not come within the provisions of section 117(a) of the Internal Revenue Code of 1939, and section 1222(3) of the Internal Revenue Code of 1954 as determined by respondent.

Respondent contends, in the alternative, that should it be decided that the disposition was a sale resulting in long-term capital gain, a part of the amounts received by petitioners in each of the years here involved was in payment of interest and taxable to petitioners as interest income under section 22(a) of the Internal Revenue Code of 1939 and section 61(a) of the Internal Revenue Code of 1954.

Findings of Fact.

Petitioners Clay B. Brown and Dorothy E. Brown are husband and wife residing in Portland, Oregon. They filed joint Federal income tax returns for the years, 1954, and 1955 with the district director of internal revenue for the district of Oregon.

Petitioners Donald L. Brown and Ingrid R. Brown are husband and wife now residing in Portland, Oregon. They filed joint Federal income tax returns for the years 1954, 1955, and 1956 with the district director of internal revenue at San Francisco, California. For the calendar year 1953 petitioner Donald L. Brown filed a separate Federal income tax return with the district director of internal revenue at San Francisco, California.

Petitioners Charles William Booth and Nancy H. Booth are husband and wife residing in Milwaukie, Oregon. They filed joint Federal income tax returns for the years 1953, 1954, 1955, and 1956 with the district director of internal revenue for the district of Orgeon.

Petitioner Philip F. Brown and petitioner Marilyn Brown, who reside in Portland, Oregon, each filed a separate income tax return for each of the years 1953, 1954, 1955, and 1956 with the district director of internal revenue for the district of Oregon.

Petitioner Clay B. Brown (hereinafter sometimes referred to as petitioner) has for many years been engaged in the lumber business as an executive of various lumber concerns. He is the father of Donald L., Philip F., and Marilyn Brown.

Clay Brown & Company (hereinafter sometimes referred to as the corporation) was incorporated under the laws of the State of Oregon on September 28, 1946, and until its dissolution on February 4, 1953, was qualified to do business in California. The corporation had authorized capital stock of 50,000 shares, par value $1 per share. Thirty-two thousand shares were issued and outstanding as follows:

Name	Date Acquired	No. of Shares	Cost	Official Title in Clay Brown & Co.
Clay B. Brown	9-30-46	6,000	$6,000.00	President
Dorothy E. Brown	9-30-46	6,000	6,000.00	None
Donald L. Brown	9-30-46	6,000	6,000.00	Ass't. Vice Pres.
Philip F. Brown	9-30-46	6,000	6,000.00	None
Marilyn Brown	9-30-46	6,000	6,000.00	None
Charles W. Booth	12-50	1,000	7,993.00	Secretary-Treasurer
Nancy H. Booth	4-52	500	4,000.00	None
C. A. Hill		500		Vice President

From the date of its incorporation through 1949, the corporation was engaged in the business of selling forest products at wholesale. In 1949 the corporation acquired millsite property at Fortuna, California and constructed thereon a gang mill and planning mill with substantially all new equipment. The gang mill and planning mill were put into operation during February 1950. In the spring of 1951 the corporation completed an additional unit consisting of a circular sawmill which was converted into a band sawmill during the fall of 1951. The gang mill, of a Swedish design, was the first of its type in California. The gang mill lent itself to the utilization of the small timber in the area, and permitted the conversion into merchantable lumber of timber previously ringed and permitted to die by ranchers in the clearing of grazing land. The output of the gang mill, planing mill, and band saw-

mill was sold through the sales and executive offices of the corporation maintained in the United States National Bank Building, Portland, Oregon. The corporation also maintained a sales office in San Francisco.

Balance sheets of the corporation contained in its income tax return for the fiscal year ended April 30, 1952, and a financial statement for January 31, 1953, set forth assets, liabilities, and stockholders' equity on the indicated dates as follows:

Assets	April 30, 1952	January 31, 1953
Cash	$ 13,457.87	$ 30,738.41
Receivables (less reserve for bad debts)	135,076.99	117,332.76
Inventories	156,765.18	458,112.44
Capital assets (less reserve for depreciation)	567,282.16	521,280.79
Timber (less depletion)	75,603.55	47,549.78
Land	24,635.27	24,635.27
Miscellaneous	19,700.04	10,983.11
	$992,521.06	$1,210,632.56
Liabilities		
Accounts payable	$ 95,833.90	$ 32,263.30
Bonds, notes, mortgages	320,417.29	529,407.60
Accrued expenses	38,432.77	28,114.05
State & Federal income tax	140,055.00	126,389.98
Capital stock	32,000.00	32,000.00
Paid-in or capital surplus	13,986.00	13,986.00
Earned surplus	351,796.10	448,471.63
	$992,521.06	$1,210,632.56

The California Institute for Cancer Research (hereinafter referred to as the Institute) was formed under the name of the "Cancer Research Foundation of California" on April 26, 1945, as a nonprofit, nonstock corporation under the provisions of division 1, part 4, title 12, article 1 of the Civil Code of California for such scientific, charitable and educational

purposes as are set forth in its articles of incorporation. The Institute is an adjunct of the University of California at Los Angeles. On August 25, 1947, its name was changed to California Institute for Cancer Research. On February 25, 1957, the name was change to West Los Angeles Institute for Cancer Research.

The Institute was a tax-exempt organization under the Federal Tax laws at the time the transaction here involved was entered into.

None of the petitioners were founders of the Institute, or had any connection with or interest in the Institute, except that derived from the transaction hereinafter described. Petitioner never had heard of the Institute before he was approached by its representative as hereinafter mentioned.

During the summer of 1952, William B. Boone of the Portland, Oregon office of Dean Witter & Co., investment counselors and brokers, was informed that his Los Angeles office was in touch with a prospective client interested in acquiring or buying small companies. Boone inquired of a number of people including petitioner as to any possible interest in selling. When contacted by Boone, petitioner stated that he was not particularly interested or looking for a sale or for a buyer, but that he would sell if the price was right, to which Boone replied that he had nothing definite in mind, but might come up with something. On August 8, 1952, Boone relayed the Clay Brown & Company prospect to his Los Angeles office and was informed that the parties thought to be interested were not interested. Subsequently, Boone's Los Angeles of-

fice informed him that the Institute might be interested in acquiring Clay Brown & Company. Louis H. Seagrave, who was then chairman of the board of directors of the Institute, came to Portland and conferred with Boone and attempted to meet petitioner who was out of town. Boone then expedited a meeting between Seagrave and petitioner.

Boone received from Seagrave certain circulars or brochures. These circulars or brochures were prepared by Seagrave in consultation with a Beverly Hills attorney. This attorney, now dead, had worked out sales of businesses to Loyola University under arrangements similar to the suggestions in these brochures. Boone compared the qualifications of Clay Brown & Company to those set forth in the brochures, found the company to qualify, and discussed the substance of the brochures with petitioners.

The brochures explained the benefits to the sellers of selling their stock to the Institute and in broad outline set out how the sale would be effectuated. The benefits of persons selling to the Institute were stated therein as follows:

> 1. They can sell their business to the Institute for more than they can sell for cash, for payment over a period of years, frequently with a substantial down payment.
>
> 2. They continue to control the business operation and to draw their regular salary, and retain an interest in the profits as well, until they are ready to retire.

3. They pay only a long term capital gains tax (25% federal).

4. They protect their families from estate, inheritance and final income taxes, which, with their chief assets still invested in the company, would have been ruinous.

5. They avoid the perplexing predicament of either paying prohibitively high personal taxes on distributed corporate earnings, or risking heavy penalties under section 102 for unreasonable accumulation of surplus if earnings are not distributed.

6. They eliminate the risk that after the death of owners, the business may be subjected to a forced sale or liquidated at possible disastrous loss to their families.

7. They avoid the risk of the business being ruined by incompetent management if sold to others for payment on an installment basis, before the owners have been paid in full.

The sale itself was outlined in the brochures generally as follows: All of the stock is sold to the Institute at an agreed price. The Institute gives its note for the purchase price. The corporation is then liquidated and an agreed amount of cash out of the liquidated assets is paid to the sellers as a down payment. A real estate trust deed and a blanket chattel mortgage covering the fixed assets of the dissolved corporation are deposited with the sellers as security for the unpaid Institute note. A new operating company is formed with nominal capital, and this new com-

pany enters into a 5-year lease agreement with the Institute covering all the fixed assets of the old corporation, and agrees to pay an annual rental therefor of an amount equal to 80 percent of the new company's net earnings before taxes. The operating company also acquires the current assets and assumes the current liabilities, and gives its note to the Institute for the amount of the net current assets which note the Institute will, in turn, deposit as additional security with the sellers. The note from the operating company will be subordinated to reasonable bank loans to the operating company. The Institute will pay to the sellers annual amounts equal to 90 percent of all rentals received on its lease of assets to the operating company.

In addition the brochures contained the following observations about the sale transaction: The sellers, as a group, may own a minority interest in the operating company, but none of the sellers may be directors or corporate officers of the operating company. In this case, petitioner, being president of the old corporation, would be employed by the operating company as its general manager at a salary comparable to his old salary, and the other key personnel could carry over from the old corporation to the operating company. The operating company may be controlled by any of the sellers' trusted associates such as lawyers, accountants, etc. Due to internal revenue laws, the lease arrangement with the operating company may not exceed 5 years. However, a new lease may be entered into with another company, with other owners, officers,

and directors, in which the present sellers can likewise n a minority interest. The sale by the sellers to the Institute and the agreement on the lease between the Institute and the operating company must be at complete arm's length with no overlapping of officers or directors. Under the arrangement, the rental income received by the Institute is tax exempt. Also, if not more than 30 percent is paid to the sellers on the note in the first year, the transaction qualifies as an installment sale, and the taxes on the long-term capital gain resulting are due only in installments proportionate to the amounts paid on the note in any one year.

Boone wrote a letter dated November 28, 1952, to Seagrave in which he:

(1) Related his contacting of petitioner and enclosed financial statements of Clay Brown & Company, together with a photograph of the Clay Brown & Company plant.

(2) Invited Seagrave to visit the plant site at Fortuna, California, meet with petitioner and inspect the property.

(3) Relayed petitioner's offer of 32,000 shares at $40 per share ($1,280,000) with a cash down payment or, in the alternative, without a down payment, $45 per share ($1,440,000).

Seagrave went to Eureka, California, where petitioner met him at the airport and took him to the mill, and over the area in general to inspect the type of timber grown in the region. Seagrave spent 1½ or 2 days looking over the property and then returned to Los Angeles.

During the early part of the negotiations petitioner received advice of counsel concerning the tax consequences of the proposed sale, such advice being set forth in an 11-page memorandum to petitioner from the law firm representing him. In the memorandum the tax-exempt status of the Institute and the deductibility of the rent by the lessee corporation, as well as the long-term capital gain qualification of the amounts received by the shareholders of Clay Brown & Company, were covered. It was therein stated that "[t]he more the deal is a straight sale of the stock of Clay Brown & Company by you, the better your tax position," and the fact that the amounts received by the sellers will be derived from and limited to existing corporate assets and future corporate earnings is not inconsistent with a bona fide sale of the stock. However, petitioner was warned not to acquire an interest in the operating corporation other than that necessary to secure the unpaid balance of the purchase price for the stock. In this respect it was suggested that petitioner have a management contract with the operating corporation to run only for the duration of the pay-out period and that this contract not be tied in as a definite condition in the sale of the stock. It was further stated that "the feature which makes the proposal of the Institute possible is the fact that the new corporation will be able to deduct the rental payments paid the Institute but yet such rental payments will be exempt from taxation when received by the Institute," because other than for this feature the transaction could just as easily be consummated with any third party instead of

the Institute. It was suggested since the tax-exempt status of the Institute was an integral part of the transaction that petitioner make sure a definite ruling from the Treasury Department has been or will be obtained in this regard.

The ensuing negotiations between Seagrave and petitioner encompassed the following:

(a) A letter, dated December 17, 1952, from Seagrave to petitioner, which stated in part:

> Our difficulty is the price, or to put it another way, we feel that a $250,000 premium over reconstructed values is perhaps all a purchase will stand, especially since average earnings before taxes of $360,000 would be required to pay off a price of $1,300,000. Earnings of $360,000 per annum are a little higher than your own idea of $350,000. Incidentally, earnings before taxes for the two and one-half years to October 31, 1952, averaged about $300,000 per annum, but if we were to add back to the year ended April 30, 1952 the amount of $150,000, which would probably not be far from the amounts charged to expense for items which could have been capitalized, and assume net earnings for the current year would aggregate $350,000, the three-year average would be about $350,000.
>
> On the other hand, there is another angle not to be overlooked, namely, the prospective earnings of the new lessee company, in which stockholders of the present company could own nearly 50%. Assuming net before taxes of $350,000, earnings per annum of the new company after payment of

rental would be $72,000. Assuming that income taxes for such an amount of earnings average .33⅓% the net to surplus would be $48,000 a year or $240,000 for the five year period. The net equity accruing to the 49% interest in the new lessee company would amount to $117,000 additional. This would increase the total proceeds of the sale to $1,417,000, which is the equivalent of $44.28 a share.

(b) By another letter dated December 17, 1952, Seagrave requested a pro forma balance sheet for Clay Brown & Company for October 31, 1952, substituting values that Seagrave and petitioner had discussed and also requested a copy of the complete audited statement for April 30, 1952. The audited statement was sent to Seagrave on December 22, 1952.

(c) By letter dated December 23, 1952, Booth sent to Seagrave the requested pro forma balance sheet for Clay Brown & Company as of October 31, 1952, wherein the statement of assets was brought up to date and adjusted values for the assets were substituted in place of book values and certain expense items were capitalized. The total adjusted value for the corporate assets shown on the pro forma balance sheet was $1,825,032. The total liabilities at this time were approximately $769,000, which figure had been previously conveyed to Seagrave, resulting in a net worth of approximately $1,050,000 for October 31, 1952. The corporate liabilities mentioned above included $125,000 in notes owed by the corporation to petitioner and his wife.

(d) The appraised values used for the pro forma balance sheet, to which the above-mentioned adjustments were made, were taken from an appraisal made by the General Appraisal Company dated July 21, 1951, which appraisal was supplied to the Institute. The appraisal set forth the following asset values:

New Replacement	Depreciated	Insurable
$760,545.44	$650,447.10	$556,764.49

The "new replacement" value, as adjusted, was the one utilized in arriving at the $1,050,000 net worth mentioned above. In a letter dated January 7, 1953, Seagrave requested the appraisal be brought up to date and such was accomplished 1 week later by the General Appraisal Company. The supplemental appraisal, based on the original appraisal for insurance purposes, set forth the following asset values:

New Replacement	Depreciated	Insurable
$836,759.43	$703,523.88	$585,636.62

Seagrave met with petitioner in Portland for negotiations which lasted several days. The principal point of discussion was the price. The price ranged from the initial asking price of about $1,500,000 which included the two notes payable to petitioner and his wife in the total amount of $125,000 down to the $1,300,000 including the $125,000 of notes, which was eventually agreed to. At no time during the discussions between petitioner and representatives of the Institute concerning the price of the stock was any mention made of interest on the deferred payment or an increase in the purchase price in lieu of interest.

Both parties considered the amount to be paid for the stock in excess of the reconstructed net worth of the corporation in terms of going concern value and earnings record. At one point in the negotiations Boone felt that the whole deal was going to fall through.

Minutes of meetings of the Institute's board of directors reflect the following details, among others, regarding the prospective transaction with the selling shareholder:

(a) The minutes of January 6, 1953, relate that the chairman (Seagrave) read a summary of the situation affecting Clay Brown & Company, and that after Seagrave obtained additional information, supplemental statistics, and documentary data, he would present these to the Institute's committee on industrial investments. The summary referred to above, among other things, states:

> 16. Assets as appraised by General Appraisal Co., July 1951, with adjustments for items since capitalized, expensed or not included in appraisal, result in net worth of $1,049,877. To this can be added $15,000 of equipment to be transferred to company making total of $1,064,877. Six percent interest on deferred balances, assuming an average of $60,000 earnings per annum would total $237,112.
>
> | | |
> |---|---|
> | Total worth | $1,064,877 |
> | Interest | 237,112 |
> | | $1,301,989 |

The interest on deferred balances was computed as follows:

		6%
Price	$1,300,000	$ 78,600
1st year payment	259,200	
Balance	$1,040,800	$ 65,080
2nd year payment	259,200	
Balance	$ 781,600	$ 46,896
3rd year payment	259,200	
Balance	$ 522.400	$ 31,344
4th year payment	259,200	
Balance	$ 263,200	$ 15,792
5th year payment	263,200	
	-0-	$237,112

(b) The minutes of January 27, 1953, set forth a resolution which appointed a legal committee to go over a proposed purchase agreement and lease and license agreement, both documents being integral parts of the transaction with petitioners, and make any revisions they felt to be to the best interests of the Institute and to pass and approve other documents in connection with the proposed purchase. There were further resolutions authorizing the president and secretary to execute the purchase agreement and the lease and license agreement as they had been outlined subject to changes made with the approval of the legal committee. Attached to the minutes of January 27, 1953, were the following:

(1) A statement by Seagrave that petitioner had advised him as follows:

> He advised me that the new lessee California corporation to be known as Fortuna Sawmills, Inc.,

would have initial paid in capital of $25,000, but that it had an authorized capital of $50,000, and that an additional $25,000 would be paid in, if found necessary.

He also stated that he was a signer personally on the mortgage, and that he would also be a personal signer on the new mortgage to the U. S. National Bank, which would be for approximately $101,000, to which it had now been paid down. He hopes to arrange this mortgage on a five year basis, which would make the annual service of it about $23,000, and have the effect of increasing the net current assets by $80,000. If the bank does not make that arrangement, he feels sure that the bank will make it a three-year loan, on which the annual service would be about $38,000, as it has been.

Mr. Brown advises that he has been assured by the U. S. National Bank that it will continue to lend on logs and lumber, as in the past, with a line up to $400,000.

Mr. Brown read me a memo detailing the working funds they could rely on, which I have reduced to a memorandum, attached hereto. He says that he is in a position to provide funds, or to lend his personal credit to insure adequate funds. He thinks the working capital position will not be as much of a problem as it has been in the past.

(2) An earnings' summary of Clay Brown & Company as follows:

1.	Company began sawmill operation May 1, 1950		
2.	Net before taxes:		
	Year ended April 30, 1951	$415,533.	
	Year e. led April 30, 1952	145,078	(nearly $70,000 expenses)
	Six months to Oct. 31, 1952	207,567	
		$768,000	
	Average annual earnings before taxes	307,270	
	Capital items expensed during 2½ years:		
	Supplies & Tools on hand	$25,000	
	Other items	33,000	
	Labor and const. lumber	40,000	
		$98,000	
	Average annual	32,500	
	Total average annual earnings	$339,000	

(3) Statements by Seagrave as follows:

* * * * *

15. Earnings of an average of $360,000 would pay out purchase price in five years.

* * * * *

17. Clay Brown has a good reputation in Portland, Oregon, and generally throughout the lumber and plywood industry. Mr. Carvel Linden of the U. S. National Bank, Portland, stated to me January 14, 1953: "Clay Brown is a top operator. His situation is clean. I have advised him, solely because of his tax burden, to sell to you if he could come to terms with you. We think that his achievement in starting this lumber company, and producing and selling profitably the first month, and 26,400,000 of the first year at a net profit before taxes of $415,553 is a real achievement."

The Institute had approximately two dozen proposed business acquisitions brought to its attention by various brokers in Los Angeles and the Institute selected two, Clay Brown & Company being one of them. The primary motivation of the Institute in purchasing the stock of Clay Brown & Company was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money or use in cancer research. The officers of the Institute felt that the purchase price would be paid off in 5 years.

On January 17, 1953, one of petitioner's attorneys sent a letter to the Institute's legal advisor which stated as follows:

> Enclosed is our draft of a proposal to the Institute. We understand that the purchase price will be determined in the near future. As noted in the proposal, it desired to liquidate Clay Brown & Co. and start operations with the lessee corporation by February 1, 1953.
>
> It may now be in order for the Institute to make inquiry of us as to the availability of the operating lessee corporation. We will be able to furnish such a corporation, which will be a California corporation called "Fortuna Saw Mills, Inc." Such inquiry may be addressed to Fortuna Saw Mills, Inc., c/o Calvin N. Souther, 1001 Board of Trade Building, Portland 4, Oregon.

By letter dated January 24, 1953, petitioner made a proposal to sell the Clay Brown & Company stock to the Institute for a determined price and set out a procedure whereby the entire transaction could be consum-

mated. The board of directors of the Institute decided to decline petitioner's proposal and instead, as mentioned above, set about to finalize its own draft of a purchase agreement and lease and license agreement, both of which had been prepared by its attorney in consultation with Seagrave. A final draft of the purchase agreement was approved by the Institute's legal committee appointed under the resolution adopted at the January 27, 1953, directors' meeting.

Under date of February 4, 1953, the purchase agreement, approved by the Institute's legal committee, was executed by the Institute as buyer and petitioner, representing himself and the other stockholders, as seller. The agreement provided for the sale of the 32,000 shares of the Clay Brown & Company stock and two promissory notes owned by petitioner and his wife in the total amount of $125,000 for a price of $1,300,000, represented by a nonnegotiable note in that amount. The agreement provided generally as follows: A balance sheet for Clay Brown & Company will be made as of January 31, 1953, and the seller agrees to indemnify the Institute against any loss arising out of any liability not set out in the balance sheet except that liabilities for income and excess profits taxes and contract renegotiations in excess of the reserves therefore on the balance sheet are not included in the seller's agreement of indemnity but that any such excess liabilities will serve to reduce the principal amount of the note. The Institute will liquidate Clay Brown & Company and shall pay the seller $5,000 in cash, execute a lease and license agreement with Fortuna Saw Mills, Inc. (hereinafter referred to as Fortuna), and sell all the remaining

assets, other than the leased assets and the $5,000 cash, to Fortuna subject to all the liabilities of Clay Brown & Company other than the $125,000 of notes for an amount equal to the net amount of the assets transferred. Fortuna, in turn, is to assume the above-mentioned liabilities and execute its note to the Institute in payment for the assets. As security for the note given the seller, the Institute will execute and deliver to the seller a real estate mortgage or deed of trust and a chattel mortgage covering the real and personal property received by the Institute upon the liquidation other than assets sold to the lessee, as well as after-acquired property. The Institute will also assign its rights under the lease and license agreement with the lessee and the purchase note executed by the lessee to the seller and will further make a defeasible assignment of all patents, patent applications, and trademarks to the seller. The Institute is to pay the seller 90 percent of the royalties and rents received in cash by the Institute from its lessee, Fortuna, or any successor lessee under the lease until the note is paid in full. However, the Institute will be obligated to make payment on the principal note only out of the 90 percent of the rents and royalties it receives from its lessee. If not sooner paid in full, the promissory note will be due and payable January 31, 1963. The unpaid balance of the note shall bear no interest before maturity but thereafter shall bear interest at the rate of 5 percent per year. In the event the Institute shall fail to pay the seller a total of $250,000 during any 2 consecutive years of the lease, the seller shall have the right to declare the entire unpaid balance due. In the event of any default by the Institute the

seller may proceed to enforce payment of the unpaid balance against the collateral held by seller as security, and only against such collateral. No sale by the Institute of any assets received on the dissolution of Clay Brown & Company, other than those assets sold to Fortuna, will be effected without the prior consent of the seller.

Pursuant to the purchase agreement, the Institute issued a non-negotiable, non-interest-bearing note for $1,300,000 payable to the sellers ($125,000 for the notes owned by petitioner and his wife and $1,175,000 for the stock). Also, as contemplated in the transaction: A deed of trust, chattel mortgage and general assignment of intangibles were executed by the Institute under date of February 4, 1953.

The stock record book of Clay Brown & Company reflects the cancellation of all issued certificates for shares of stock as of February 4, 1953, the issuance of a new certificate in the amount of 32,000 shares to the California Institute for Cancer Research, Certificate No. 18, dated February 4, 1953 which certificate bears the following typed legend:

> Cancelled March 14, 1953 upon complete liquidation of the corporation pursuant to resolutions adopted by stockholders and directors on February 4, 1953

and the endorsement dated March 13, 1953, of the California Institute of Cancer Research as follows: "Certificate being returned for concellation."

Also under date of February 4, 1953, petitioner and the other three directors and officers of Clay Brown &

Company resigned and directors associated with the Institute were elected. Formal documents looking to the dissolution of Clay Brown & Compnay were executed by the directors representing the Institute. Among the various documents prepared for this purpose were resolutions by Clay Brown & Company to dissolve, adoption of the dissolution resolution by the Institute, a grant deed from Clay Brown & Company, Bill of Sale and Assignment for personalty and a general assignment from Clay Brown & Company to the Institute covering cash, receivables, inventory, etc. Resolutions dissolving the company, were filed, title report changed, and United States Treasury Department forms filed.

Under date of February 4, 1953, the Institute recorded the following entries reflecting the transaction:

Entry recording purchase of stock:		
Investment in stock of Clay Brown & Co.	$1,175,000	
Notes Receivable—Clay Brown & Co.	125,000	
Notes Payable Re. Fortuna Sawmills, Inc.		$1,300,00
To record purchase of all of issued and outstanding stock of Clay Brown & Co. (32,000 shares) together with two promissory notes owned by Clay and Dorothy E. Brown and executed by Clay Brown & Co.		
Entry recording liquidation:		
Current assets transferred to operating company	$ 617,115.72	
Investment in fixed assets	780,969.88	
Investment in timber	15,008.32	
Investment in timber purchase contract	104,991.68	
Excess of cost over appraisal value of assets leased to Fortuna Sawmills, Inc.	373,038.33	
Deposits	51.00	
Current liabilities transferred to operating co.		$ 499,563.6
Long term debt transferred to operating co.		91,611.2
Notes Payable, stockholders		125,000.0
Investment in stock of Clay Brown & Co.		1,175,000.0
To record receipt of assets and assumption of liabilities upon liquidation of Clay Brown & Co. as of 2/4/53		

During the negotiations with Seagrave prior to execution of the purchase agreement, it was known that an operating company was to be formed, without any decision having been made as to who would form such company. Actual formation of the operating company was considered at a meeting in Portland, Oregon, in December 1952, attended by petitioner, Seagrave, Charles W. Booth, secretary-treasurer of Clay Brown & Company, and Calvin N. Souther, attorney for petitioner and Clay Brown & Company. At this meeting Seagrave was asked if the Institute wanted to provide an operating company or had any suggestions in that respect. Seagrave had no suggestion. When petitioner was asked if he had someone in mind, he turned to Souther and inquired whether Souther would be willing to supply the operating company, Souther being familiar with the area in general through his representation of petitioner in connection with Humboldt Plywood Corporation, a prior business venture of petitioner in the same coastal region of northern California. At that time or sometime thereafter Souther acceded to petitioner's offer.

Fortuna was formed as a California corporation on January 26, 1953, with authorized capital stock of 2,500 shares, par value $10 per share. All of these shares were issued and outstanding, and were owned 2,000 shares by Souther and 500 shares by Kinsey. The officers and directors of Fortuna were:

Calvin N. Souther	president and director
Raymond P. Underwood*	vice president and director
William H. Kinsey	secretary and director

*Underwood is a member of the same legal firm as Souther and Kinsey.

Souther paid into Fortuna $25,000 for all of its stock. The 500 shares owned by Kinsey were subsequently purchased by him from Souther. The $25,000 paid by Souther into Fortuna was out of his own personal funds and was not obtained directly or indirectly from petitioner or any of the other Clay Brown & Company stockholders. Neither petitioner nor any of the other selling shareholders owned any stock interest in Fortuna.

Upon receipt of the Clay Brown & Company assets, subject to the liabilities, as liquidating distributions, the Institute did the following:

(a) Paid $5,000 cash upon the principal note.

(b) Executed a 5-year lease and license agreement with Fortuna.

(c) Sold to Fortuna all the current assets received by the Institute upon liquidation of Clay Brown & Company, except the $5,000 in cash mentioned in subparagraph (a) above, which assets were transferred to Fortuna under a general assignment dated February 4, 1953.

(d) Obtained an assumption agreement from Fortuna dated February 4, 1953, whereunder Fortuna assumed the liabilities of Clay Brown & Company (except the Brown notes in the amount of $125,000) and

wherein Fortuna agreed to pay the Institute an amount equal to the excess of the assets received over the liabilities assumed. Such excess was determined by the audit of Clay Brown & Company as of January 31, 1953, made puusuant to the purchase agreement. The excess subsequently determined by the audit was evidenced by the promissory note of Fortuna dated May 15, 1953, in the amount of $20,991.79.

The 5-year lease and license agreement between the Institute and Fortuna required Fortuna to pay to the Institute in rent and royalties an amount each year equal to 80 percent of the net profits resulting from the use and occupancy of the demised premises. The agreement additionally provided in general as follows: The net profits were defined as profits before depreciation and income, franchise, excess profits or other similar Federal or State taxes. Lessee shall compute net profits for each semiannual period and should a loss result from operations during any semiannual period, any subsequent profits may be applied to offset such loss. Lessor may at its option cancel the lease in the event the lessee shall not have paid lessor a total of $277,778 as rental and royalties during any 2 consecutive full annual periods. Lessee shall exert its best efforts to cause the demised premises to be productive of the highest possible net profits consistent with good business judgment but the rentals shall accrue only in the event that net profits are earned through the operation of the demised premises. Lessee alone shall bear any and all losses incurred by it in the operation of the business. Lessee shall maintain the demised premises in a good state of repairs, shall pay all general property

taxes levied against the premises, and keep the premises adequately insured. The lease contract will not be assigned by lessee without the consent of the lessor. During the term of this lease the majority of the voting stock of lessee must be held only by such persons as are approved by lessor. Lessor is the owner of the name and goodwill of Clay Brown & Company and lessee is given the right to use that name in the conduct of its business during the term of this lease. Until the principal note in the amount of $1,300,000 payable to the former shareholders of Clay Brown & Company has been paid in full, this lease shall not be amended without the consent of petitioner. Lessee agrees to enter into an agreement with petitioner whereby petitioner shall be employed as general manager of lessee until the expiration or sooner termination of the lease.

Pursuant to the lease and license agreement, resolutions were adopted by Fortuna's board of directors authorizing employment of petitioner and other key Clay Brown & Company personnel. Under date of February 4, 1953, petitioner executed a written employment agreement designating him as general manager of Fortuna for a term of 5 years at an annual salary of $25,000 and restricting him from activity competing with the business. Other key Clay Brown & Company personnel also remained at their jobs. No personnel from the Institute were employed by Fortuna.

Approval, satisfaction, and execution of the voluminous set of documents by the various advisors and parties lasted several weeks beyond the stipulated date of the transaction. Near the end of the task, on February 21, 1953, petitioner's attorney wrote to the legal

advisor of the Institute with respect to a proposal by the Institute to amend the deed of trust and chattel mortgage by deleting a requirement that the Institute shall keep the subject property in a good state of repair, fully insured, and pay all taxes, etc. Petitioner's attorney stated that the usual deed of trust and chattel mortgage includes the above-mentioned provisions and that such obligations are the primary obligation of the mortgagor (the Institute) even though such obligations are assumed by the mortgagor's lessee (Fortuna). He further stated as follows:

> It is the intent of the selling stockholders that such provision in the deed of trust and the chattel mortgage will not be personally enforced against the Institute but will only be used as constituting a default triggering a foreclosure of the security. Therefore if it would help matters if Clay Brown et al. gave a letter to this effect, this might be arranged.
>
> If for any reason the lease to Fortuna Sawmills, Inc. should be terminated and the Institute should not be able to immediately re-lease the properties, it is my understanding that the Institute would turn the properties back to the selling stockholders without the necessity of any foreclosure on the security. If this is the case then it would seem that the obligations contained in the subject provisions would never have any affect upon the Institute, because their only purpose is to trigger a default and as before stated the Institute plans to turn back the properties in any event so whether there is a default seems immaterial.

In short, this seems to be one of those situations where one party (Clay Brown et al) want a provision included on the theory it will not come into effect or create any obligation unless an unusual situation arises which the other party (the Institute) claims will never arise; while on the other hand the other party (the Institute) wants the provision deleted because it feels that there is no necessity for same. If the foregoing is a correct analysis of the situation we wish to suggest that there may be a reason of mutual interest to the Institute why the provisions should be included. For tax reasons we want the transaction to look as much as possible like an ordinary purchase of stock by the Institute and the leasing of the assets received upon liquidation to an independent lessee. I believe the maintenance of this picture will be helped by the deed of trust and mortgage containing the standard provisions and might be hurt where the Institute transfers all of its obligations in respect to maintenance of the property to the lessee. We have done all we could to help the tax picture, such as not having Clay Brown own any stock in the lessee corporation, and we believe that inclusion of the provisions might have a beneficial effect in this same direction.

By letter dated February 26, 1953, the selling shareholders conveyed to the Institute their assurance that they would not enforce against the Institute personally its obligation to maintain the demised property but in case of such default the selling shareholders would only be entitled to proceed with foreclosure.

Neither petitioner nor any of his representatives ever sought to find out about the Institute's financial condition at the time of the transaction. At that time the Institute's financial resources fluctuated from nothing to $200,000 or $300,000 depending upon the demands of the university for research. The Institute's funds are expended almost exclusively for cancer research, if not solely for such purpose.

The changeover from Clay Brown & Company to Fortuna was accomplished without any shutdown of the mills, disruption in production or the mechanics of operation. No changes were made in personnel below the level of directors and officers. The customary steps a new corporation takes in entering the business world were accomplished, i.e., bank accounts were set up, registration with the various agencies such as unemployment was changed, insurance policies were changed, the name on the door of the Portland office was changed, and the telephone listing amended. A whole new set of books was set up by Fortuna. A printed notice was sent to the trade relating the changeover from Clay Brown & Company to Fortuna. The stationery was changed by overprinting "Fortuna Sawmills, Inc. successor to" in the space above the "Clay Brown & Company" on the letterhead. Record keeping remained at the Portland executive office. The procedure now was for Fortuna to remit to the Institute its check for 80 percent of the net profits as per the lease and license agreement and for the Institute to remit its check for 90 percent of the amount received from Fortuna to the former shareholders of Clay Brown & Company as per the purchase agreement.

Fortuna harvested over 20,000,000 feet from the timber interests assigned to it by the Institute which the Institute had received upon liquidation of Clay Brown & Company. This is substantially more than the 15,000,000 feet estimated on the balance sheet showing adjusted values for assets as of October 31, 1952. Also, the amount per thousand feet used in determining adjusted values was $8.20 per thousand board feet whereas Clay Brown & Company had received an independent appraisal as of May 1, 1952, of $9 per thousand board feet.

The assets of Clay Brown & Company were subject to a mortgage to the U. S. National Bank of Portland, Oregon in participation with the Reconstruction Finance Corporation. The bank and the RFC consented to the transfer of the property by Clay Brown & Company to the Institute, and likewise consented to a lease of the assets by the Institute to Fortuna in consideration for the assumption of the mortgage by Fortuna and petitioner's continuing personal guaranty of the debt.

Petitioner acted as general manager of Fortuna until he resigned effective October 31, 1954, to become the president of M and M Wood Working Company. Petitioner received a salary of $40,000 per year as president of M and M Wood Working Company. In his resignation petitioner waived his rights under the lease and license agreement to approve any successor to act as manager of Fortuna. Petitioner was retained by Fortuna in an advisory capacity at a salary of $1,000 per month and in such capacity he continued to watch over Fortuna's activities and continued to have the authority to sign corporate checks.

In the conduct of its operations Fortuna borrowed money from the United States National Bank of Portland, Oregon. There were 27 such loans from July 27, 1953, to May 13, 1957, ranging in amounts up to $55,214. One of the loans, for $50,000, was guaranteed personally by petitioner. The other 26 loans were secured by warehouse receipts or chattel mortgages on logs owned by Fortuna. The bank records disclose that the bank had a file designated "Fortuna Sawmills, Inc.", which was separate both from petitioner's personal file and the file for another one of petitioner's corporate enterprises.

Revenue Ruling 54-420, 1954-2 C.B. 128, was published in the fall of 1954, after Fortuna had been operating under the lease for more than 18 months. Petitioner's counsel brought this ruling to petitioner's attention by letter dated November 3, 1954, in which he recommended that the lease and license agreement between the Institute and Fortuna be amended to eliminate the requirement of a management contract between Fortuna and petitioner and further that the rental paid by Fortuna to the Institute be changed from 80 percent of the net profits to $5 per thousand board feet handled at the mill. It was stated that the $5 per thousand board feet rental would be a fair rental and that, based on the past operations of Fortuna, would produce a larger rent payment than the 80 percent.

In 1955 there was considerable flooding of the Eel River which is adjacent to Fortuna's millsite, causing considerable damage to the mill. At this time George Castera, president of the Institute, contacted a high

ranking Pentagon official with the hope of having the river repaired.

The sales prices of lumber began a steady decline in early 1956 without any corresponding decrease in costs. According to the company books Fortuna incurred a loss of $125,346.89 for the 6-month period November 1, 1956 through April 30, 1957. Market conditions worsened thereafter. The cause for the decline was in part due to a recession in the construction industry and also Fortuna was adversely affected by a change in the railroad rates for hauling freight. The fall in the lumber market in 1957 was not foreseeable in 1953 when the sale transaction between petitioner and the Institute was consummated.

The mill operations at Fortuna were shut down and discontinued on or about June 19, 1957. Operations were never resumed by Fortuna, and in a letter dated December 6, 1957, Fortuna called the Institute's attention to the expiration of the lease on January 31, 1958, and expressed a lack of desire on the part of Fortuna to negotiate a new lease. The Institute was notified that the carrying charges of the shutdown property amounted to $3,200 a month which would no longer be the obligation of Fortuna after expiration of the lease on January 31, 1958. In the letter dated December 6, 1957, it was stated that as of the termination of the lease there would be certain items of prepaid insurance and taxes respecting the assets to be turned back over to the Institute for which Fortuna claimed reimbursement and it was suggested that such reimbursement could be made by way of deductions from

the face amount of the $20,997.79 note which had been executed by Fortuna to the Institute.

Under date of December 12, 1957, petitioner notified the Institute that he was instructing Souther that any payments made by Fortuna on the note in the face amount of $20,991.79 which had been assigned to him as additional security were to be paid directly to him. By letter dated January 10, 1958, petitioner made claim against Fortuna on behalf of himself and the other selling shareholders for the full amount of the note undiminished by any charges or claims which Fortuna might have against the Institute. In reply to this claim Fortuna on January 31, 1958, remitted a check to petitioner in the amount of $17,304.92, being the face amount of the note reduced by the above-mentioned items claimed by Fortuna against the Institute totaling $3,686.87. Fortuna took the position that the note represented a debt owed by Fortuna to the Institute, with petitioner's interest being only for security and therefore any claims Fortuna had against the Institute could be charged to the note. The payment by Fortuna was made subject to the condition that if it were determined that the Institute owed Fortuna another amount, relating to a claim for overpayment of rent by Fortuna to the Institute, Fortuna could take satisfaction out of the present payment to petitioner.

Also in the aforementioned letter dated December 12, 1957, petitioner notified the Institute that a default existed under the mortgage, and that unless the Institute could give some definite assurance prior to February 1, 1958, that it would be able to re-lease the prem-

ises or otherwise dispose of them in a satisfactory manner, petitioner would have no alternative but to foreclose the mortgage.

In a letter dated January 17, 1958, addressed jointly to petitioner and Fortuna, the Institute denied the existence of a default, and asserted an additional rental claim against Fortuna of $94,888.38 for the 6-month period May 1, 1956, through October 31, 1956. The Institute took the position that Fortuna's earnings for the 6-month period ended October 31, 1956, generated rental of $94,888.38 notwithstanding the fact that losses incurred by Fortuna in the second half of the year ended April 30, 1957, resulted in a net loss for the whole year. The letter stated in part as follows:

> It is our understanding that in the temporary withholding of rent due us for the six month period ending October 31, 1956, based upon profit for that period, Fortuna Sawmills, Inc. was acting with the consent of Mr. Clay Brown, such that this procedure would not be used by Mr. Brown or the other sellers to create a default under the terms of our purchase agreement with them dated February 4, 1953. Consequently, we are not aware of any present default under the purchase agreement.

Fortuna answered the Institute's additional rental claim in a letter dated January 29, 1958, wherein Fortuna denied the liability and claimed an overpayment of rental in the amount of $55,948.36, for the full lease term. Fortuna took the position that the rental due the Institute was to be determined from profits

computed on a cumulative basis over the term of the whole lease and that on this basis it had overpaid its rent to the Institute in the amount of $55,948.36.

Petitioner answered the Institute's letter of January 17, 1958, in a letter dated January 30, 1958, wherein petitioner disagreed both with the Institute's claim for additional rental, and with Fortuna's claim of overpayment. Petitioner informed the Institute that if it should be determined that Fortuna actually overpaid the rent so that the Institute was required to reimburse Fortuna, the Institute should not look to the sellers of the stock of Clay Brown & Company for return of any of the purchase price. As for the Institute's denial of a default, petitioner stated as follows:

> Whether a default presently exists under the mortgage should be immaterial by the end of this month since at that time there will definitely be a default under Paragraph VII of the purchase agreement, and also under the provisions of the mortgage obligating you to keep the property insured, etc., if you fail to comply with such obligations on and after February 1, 1958. A default is pertinent only in regard to foreclosure, and I would much rather receive the remaining balance of the purchase price than foreclose on the property. If you are able to suggest any alternative to foreclosure I will be happy to consider same. It is necessary that we all recognize the realities of the situation since some definite decision will have to be made and action taken immediately.

The selling shareholders and the Institute settled their differences by agreement made on June 3, 1958, as of February 1, 1958, providing for the retention of ownership and possession of the property by the Institute with an obligation to pay upon the principal note 90 percent of any net proceeds realized from rental or sale of the property. The agreement provided in addition generally as follows: The sellers are required to pay all sums necessary to care for, maintain, and preserve the property including taxes. The 10 percent of the net proceeds of any lease or sale of the property will be payable to the Institute notwithstanding the fact that the face amount of the principal note, in the amount of $1,300,000 has not been paid. The agreement will extend to December 31, 1958, and thereafter unless the sellers give notice of termination. Upon a written notice of termination the agreement will remain in effect for a reasonable period beyond the designated termination date if on such date there is pending a negotiation or proceeding for condemnation of the property or if the Institute is engaged in negotiating a sale of the property upon terms satisfactory to the sellers to permit a conclusion of such proceedings or negotiations. In any event the Institute will be allowed a reasonable time beyond the stated termination date to effect a forced sale of the property at public auction. During 1958 the Institute leased the properties for a short period to a lessee other than Fortuna on the basis of $3.50 per thousand feet of lumber manufactured. Sometime prior to January 24, 1958, the Division of Highways, State of California, had been considering condemning part of the millsite at Fortuna, California. The Institute was

able to prevail upon the highway department to purchase the entire property rather than to condemn a part. In July 1959, the property was sold by the Institute to the highway department for $300,000, payment being made to the parties pursuant to the agreement, effective February 1, 1958, as follows:

Expenses of sale	$ 8,781.68
10 percent of residue to Institute	29,121.83
90 percent of residue to promisees of principal note	262,096.49
	$300,000.00

The $8,781.68 expenses of sale included $8,765.48 paid to one of petitioner's corporate enterprises in reimbursement for payments for taxes and maintenance of the property which it had made.

Upon sale of the assets to the highway department and the disbursement of the proceeds, the entire sales agreement between the selling shareholders and the Institute was terminated.

The following table shows Fortuna's net profits before payment of rent and income taxes, the amount of payments made by Fortuna under the lease and license agreement to the Institute and the amount of payments by the Institute to the shareholders on its note for the years involved in the sale transaction:

Period covered	Fortuna Net Profit Before Rent and Income Taxes	Payments by Fortuna to Institute per Lease and License Agreement		Payments by Institute on Promissory Note
		80 Percent of Net Profit	Other	
February 4, 1953-April 30, 1953	$ 46,206.91	$ 36,945.53		$ 38,250.98
May 1, 1953-April 30, 1954	(4,748.23)	7,496.84	[1]$ 1,796.08	13,829.14
			[1]84.23	
			[2]5,201.67	
May 1, 1954-April 30, 1955	521,585.16	396,019.61	[2]4,098.00	360,515.65
May 1, 1955-April 30, 1956	331,867.84	263,387.55	1,450.00	238,498.80
May 1, 1956-April 30, 1957	(6,736.42)	142.50		
Sub-totals	$888,175.26	$703,992.03	$12,629.98	$651,094.57
May 1, 1957-October 31, 1957	(83,681.21)		[3]20,849.29	20,849.29
November 1, 1957-April 30, 1958			[2]989.00	989.00
May 1, 1958-October 31, 1958				
November 1, 1958-April 30, 1959			[4]1,102.50	1,102.50
May 1, 1959-October 31, 1959				$674,035.36
				[5]262,096.49
				$936,131.85

[1]Workmen's compensation dividend.
[2]Proceeds from sale of capital assets.
[3]Settlement of $20,991.79 promissory note given to Institute by Fortuna.
[4]Proceeds of sale of right-of-way and sale of capital assets.
[5]Proceeds of sale of assets to California Highway Department.

Each petitioner determined his gain on the sale of his stock by treating the amount to be received as his proportionate share of $1,175,000 (the $1,300,000 face amount of the note less the $125,000 of notes) and subtracting therefrom the basis of his stock. Each petitioner reported his gain upon the installment basis on his returns determining the amount that constituted gain in each year by applying to the amount he received from the Institute in that year the percentage that his total gain on the sale bore to the total amount to be received. Each petitioner treated his gain in each year as long-term capital gain. Respondent, in his notice of deficiency, computed the gains from the transaction by the same method petitioners had used on their returns but added to each petitioner's basis for his stock his allocable portion of the amount of $1,500.82 representing legal fees paid by Clay Brown & Company in 1953 which respondent determined constituted a constructive pro rata dividend to petitioners. Respondent determined that each petitioner's gain arising from the transaction in each year as so computed constituted ordinary income.

Some of the facts have been stipulated and are found accordingly.

Ultimate Findings.

The agreement entered into between petitioners and the Institute under date of February 4, 1953, constituted a bona fide sale of petitioners' stock in Clay Brown & Company to the Institute for a price arrived at in an arm's-length transaction. The amounts received by petitioners from the Institute pursuant to this agreement are proceeds from the sale of their stock.

The principal amount of the note given by the Institute to petitioners in payment for their stock in Clay Brown & Company and the note of that corporation to Clay B. Brown and Dorothy E. Brown was $1,300,000. This note was without interest until maturity. In arriving at the sales price of the stock, no consideration was given by the parties in their negotiations to an amount in lieu of interest.

Opinion.

The primary issue presented is whether petitioners are entitled to treat the gain realized by them upon the disposition of the Clay Brown & Company stock as a long-term capital gain. Respondent contends in the alternative that if it should be decided contrary to his determination that the gain realized by petitioners is long-term capital gain, part of the amounts received by petitioners is properly attributable to interest and thus taxable as ordinary income.

Petitioners' position is that the gain they realized resulted from the sale of a capital asset, the stock of Clay Brown & Company, held for over 6 months and, consequently, they are entitled to report the gain as a long-term capital gain.

Respondent first argues that, if it be assumed that the petitioners have, in fact, sold their stock in accordance with the numerous documents which purport to reflect such a sale, the petitioners retained such an economic interest in and control over the property sold that the transaction should not be treated as resulting in long-term capital gain for purposes of Federal income tax, citing Gregory v. Helvering, 293 U.S. 465 (1935);

Higgins v. Smith, 308 U.S. 473 (1940); Griffiths v. Helvering, 308 U.S. 355 (1939); and Burnet v. Harmel, 287 U.S. 103 (1932).

Respondent asserts that in the transaction the selling shareholders retained control of the corporate assets via the security instruments executed by the Institute and the management contract between Fortuna and petitioner and retained control of the profits by receiving them as payment on the purchase price. On the other hand, respondent observes, the buyer, the Institute, neither put up assets of its own nor assumed any risk with respect to the purchase.

Respondent's second contention is that the numerous documents present in this case, though cast in terms of, and presenting a picture of, a sale, did not, in fact, represent the substance of the transaction intended by the parties, the transaction in substance being an arrangement whereby petitioners would siphon off the profits from the corporate business at capital gain rates and then terminate it by the Institute turning back the properties to petitioners. Respondent asserts that it was the intention of the parties that the payments by the Institute on the purchase price at the rate of 90 percent of the Institute's receipts from Fortuna would be stopped and the property reacquired by the petitioners any time the petitioners deemed such reacquisition appropriate. Respondent contends that this result could be accomplished under a tacit agreement to this effect which he asserts existed between petitioner and the Institute or by petitioner's having Fortuna withhold payments to the Institute, thus "triggering" a default on the purchase agreement.

Both of respondent's contentions are based on a lack of substance to the purported sale, his first argument assigning as a reason that the transaction did not change the control over and economic benefits from the property and his second that it was never the intent of the parties that the Institute actually acquire the properties.

The facts in the instant case do not support either of respondent's contentions. Petitioners by the transaction here involved parted with their equitable ownership of the assets when they transferred their stock to the Institute and became the creditors of the Institute with mortgages and a management contract as security for the payment of the purchase price of the stock. This change of interest constitutes a change of economic benefits thus distinguishing this case from the cases relied on by respondent.

Griffiths v. Helvering, supra, and Higgins v. Smith, supra, each involved a transaction whereby assets were sold or transferred to a corporation wholly owned by the taxpayer. The Supreme Court held in each instance that the taxpayer by virtue of his 100 percent stock ownership of the corporation had as much economic interest in and control over the assets as if he held them outright. In Burnet v. Harmel, supra, the taxpayer leased oil lands in return for a bonus, i.e., a down payment, and a royalty on all oil produced. The lease was for 3 years and thereafter as long as oil was produced, the oil which had not been extracted to revert to the lessor upon termination of the lease. The Supreme Court held that the transaction did not constitute a sale of the oil in place for tax purposes because the passage

of title to the oil to the lessee was merely incidental to his primary right acquired under the lease which was the right to go upon the land and drill for oil.

In the present case the stock was transferred outright to the Institute and such transfer was basic to the entire transaction. Here there would be no reversion to petitioners of the assets which the Institute received from the stock sold to it unless there was a default in the payments on the notes given for the stock. The interest of the petitioners would continue not infinitum as in Burnet v. Harmel, supra, but only until the purchase price of the stock was paid. Gregory v. Helvering, supra, involved a transaction which the Supreme Court held was "an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character * * *." There was a clear business purpose in the instant case on the part of all parties thereto. Petitioners were able to sell their stock at a price agreeable to them, the Institute obtained funds by the retention of 10 percent of the rental payments from Fortuna and expected to obtain funds from the sale of the assets after the note was paid in full, and the stockholders of Fortuna expected that corporation to have income from the 20 percent of its operating profits that it was to retain.

Respondent argues that petitioners would not have been interested in the transaction had they not thought that the profits received on the sale of the stock would be taxable as long-term capital gain. Assuming that respondent's argument in this regard is correct, it does not follow that there was a lack of substance to the

sale of the stock. It may be, as respondent contends, that petitioner would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization. This fact does not indicate that there was no business purpose in the sale. As the court stated in Gregory v. Helvering, supra, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes or altogether avoid them, by means which the law permits cannot be doubted." Certainly, the right of a taxpayer by legal means to increase the amount received from a transaction over what he might have received from a different transaction is fundamental. So long as a sale to an exempt organization of stock in a corporation engaged in a commercial business is legal, such a sale, where it is in substance as well as in form a sale, is not to be ignored for tax purposes solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay.

The capital gains provisions of the Code constitute an exception to the normal tax requirements and are to be narrowly construed, Raymond Bauschard, 31 T.C. 910, 916 (1959) affd. 279 F. 2d 115 (C.A. 6, 1960), and cases there cited. Even a narrow construction of these provisions does not support a conclusion that they should be inapplicable to a sale to a tax-exempt organization.

Respondent's second argument is based on his assertion that in substance there was no sale, it being the intent of the parties that at some future date the assets would be returned to petitioners. In support of his position respondent relies primarily on statements in a letter written by one of petitioners' attorneys to the attorney for the Institute wherein reference is made to the pos-

sibility that a situation might arise creating a default under the mortgage warranting a foreclosure. The portions of this document relied upon by respondent are set forth in our findings. In our view the reference to returning the properties to petitioners is intended to refer only to the situation in which petitioners would have the right otherwise to foreclose on the properties. George Castera, president of the Institute, testified unequivocally that the main reason the Institute entered into the transaction was that it hoped that the note could be paid off and the Institute obtain the properties which it planned to sell to obtain money for use in cancer research.

Upon consideration of all the evidence in this case we hold that the transaction constituted a bona fide sale by petitioners to the Institute arrived at in arm's-length negotiations and devoid of any tacit understanding of the parties to collapse the deal at a time deemed appropriate by petitioners or of any plan or arrangement for artificially triggering a default.

There is substantial evidence in the record in addition to Castera's testimony to support our conclusion. The Institute was not a creation of petitioners but had been in existence a number of years before the transaction here involved occurred. It was the moving party in seeking a corporation to buy. The Institute took steps to ascertain exactly what it was purchasing. Seagrave spent a day and a half or 2 days looking over the business premises at Fortuna. The Institute requested balance sheets, statements of earnings and asset appraisals from petitioner. Petitioner was requested to bring the balance sheet and asset appraisals up to date. The In-

stitute inquired into petitioner's business reputation. Numerous drafts of the proposed purchase agreement and related documents were made by the parties.

The price of $1,300,000 (including the $125,000 of notes) was the result of real negotiating. It was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets. The lease and license agreement between the Institute and Fortuna required that the majority of the stock in Fortuna be held only by persons approved by the Institute. In 1955 when the millsite property at Fortuna was damaged by river flooding, Castera contacted a top ranking Pentagon official with the hope of having work done on the river. In 1957 a real dispute arose between the Institute and Fortuna respecting the amount of rent due the Institute. Fortuna was organized with more than nominal paid-in capital and the amount was paid by and the stock held by persons other than petitioners. Since these persons were petitioner's attorneys, it may be that they were willing to organize and finance the operating company in reliance on petitioner's ability as the manager of that company, but this is merely another way of saying that with petitioner as manager, they hoped to make a profit from their investment in the operating company, which certainly is a bona fide business purpose.

These facts and others set forth in our findings negate respondent's contention that the transaction was a sham.

Respondent relies primarily upon Emanuel N. (Manny) Kolkey, 27 T.C. 37 (1956), affd. 254 F. 2d 51 (C.A. 7, 1957), in support of his second argument.

That case involved a factual situation distinguishable in many respects from the instant case. There, the tax-exempt organization was sought out by the seller, the stock was transferred to a new operating company, the stock of which was owned by the tax-exempt organization, with dividends to be paid to the tax-exempt organization, the selling price for the stock was almost four times its fair value, the new operating company was set up with an extremely short cash position, the business was highly speculative, its effectiveness had been impaired by adverse governmental rulings, and the operating company stock was transferred to the original sellers of the old corporation stock after 11½ months. Cf. Estate of Ernest G. Howes, 30 T.C. 909, 925 (1958), affirmed sub. nom. Commissioner v. Johnson, 267 F. 2d 382 (C.A. 1; 1959). On the facts present in Emanuel N. (Manny) Kolkey, supra, the conclusion was reached that there had been, in fact, no sale of the corporate stock but rather that the stock had been contributed to the new operating company as equity capital and the amount received at the time of the purported sale constituted a taxable dividend.

In the present case we have a transaction whereby petitioner parted with their stock to an unrelated company for the considerations covered in the agreements negotiated at arm's length. The following language in Union Bank v. United States, 285 F. 2d 126, 128 (Ct. Cl. 1961), which dealt with a transaction quite similar to the instant case, is equally applicable to the facts here present:

> From the standpoint of the Goldenbergs, they were, before the 1951 transaction, the owners of

valuable properties and a valuable going business. * * * After the 1951 transaction the Goldenbergs had no interest in these assets, except a security interest, the power to take them back in case of default in payment for them. If they increased in value because of general prosperity or business success, or in dollar value because of inflation, the Goldenbergs would get no part of that important incident of ownership. * * * .

We think it is logically and legally impossible for an owner to part with his property, for a consideration, without selling it. The consideration which he gets for parting with his property is not income from the property, but is the price of his parting with the property.

We hold that the profit received by petitioners from the sale of their stock to the Institute constitutes long-term capital gains.

Respondent contends in the alternative that should it be decided that the disposition of the Clay Brown & Company stock qualifies for long-term capital gain treatment, part of the payments received by petitioners from the Institute constitutes payments of interest on the unpaid balance of the purchase note taxable as ordinary income. Respondent states that the factor of interest was contemplated by the parties in arriving at the ultimate purchase price and that the rate so contemplated was 6 percent.

We have found as a fact that interest was not contemplated by the parties in arriving at the ultimate purchase price. Petitioner specifically justified the price he was asking on the basis of the value of the business

as a going concern and its earnings record. The Institute in dealing with petitioner discussed the amount it was willing to pay for the business on a similar basis. The finally agreed price was arrived at in an arm's-length transaction and it was specifically provided both in the purchase agreement and the note executed pursuant thereto that there was to be no interest due on the unpaid balance of the note prior to the date of maturity which would occur on a specified date or an accelerated date upon failure of the Institute to pay a specified sum over any 2 consecutive years, neither of which events occurred. The summary of the statement read by Seagrave contained in the minutes of the meeting of the board of directors of the Institute of January 6, 1953, contains, among other reasons for justifying the price to be paid for petitioners' stock, a computation of the amount that interest at 6 percent on the unpaid balance of the appraised value of the assets would total over a 5-year period. This was merely a part of a statement by a representative of one party to the transaction and formed no part of the negotiations between the parties or the agreement between them as to the purchase price of the stock.

We have consistently refused to consider a portion of a total purchase price as constituting interest where as here the agreement of the parties was clearly for a price without interest. Carl Lang et al., 3 B.T.A. 417 (1926); Elliott Paint & Varnish Co., 44 B.T.A. 241 (1941); and M. C. Parrish & Co., 3 T.C. 119 (1944), affd. 147 F. 2d 284 (C. A. 5, 1945). Cf Brandtjen & Kluge, Inc., 34 T.C. 416, 447 (1960) and cases there cited.

The circumstances in Elliott Paint & Varnish Co., supra, are quite similar to those here involved, the primary distinctions being that in that case the seller had made the unilateral interest computation in considering the price she was willing to take and the purchaser was not a tax-exempt organization. The question in Elliott Paint & Varnish Co., supra, concerned the deductibility of interest by the purchaser. Absent a statutory provision to the contrary, the same rules should govern in determining whether interest is includible in income by the seller as are used to determine whether interest is deductible by the purchaser. Since we have held that the transaction between the petitioner and the Institute was arm's length and was not a sham and that the price negotiated by the parties was not intended to include an element of interest, the factual distinctions between the instant case and Elliott Paint & Varnish Co., supra, are not significant.

We have, in cases in which monthly payments on property designated as rental were held in fact to be payments on the purchase price, found that a part of each payment constituted interest where the evidence showed that the agreement between the parties contemplated a payment in the nature of interest. Judson Mills, 11 T.C. 25, 33, 34 (1948). We have also considered a discount from the face amount of a loan to be deductible as interest. John Randolph Hopkins, 15 T.C. 160, 181 (1950). Cf. M. C. Parrish & Co. supra, in which a note issued at a discount was distinguished from a deferred price which might be higher than a cash price.

Respondent's argument that a part of the payments received by petitioner was in fact interest is again an attack on the transaction as not bona fide, his contention being that interest was actually considered by the parties "but remains hidden behind the veil of documents evidencing the ultimate price of the stock." We have found that interest was not considered in negotiating the price of the stock, that the transaction was bona fide and did in substance as well as form constitute a sale by petitioners of their stock in accordance with the terms set forth in the purchase agreement, a part of which was the provision that the note given to petitioners was without interest.

Even if the evidence supported respondent's contention that the purchase price of $1,300,000 had been shown to contemplate $237,112 of interest, it would not follow necessarily that any portions of the payments made in the years here involved were interest. Where a payment is made on an interest-bearing debt without designation by either party as to whether the amount is to be credited to principal or interest, the payment will first be credited to interest and then to principal, Theodore R. Plunkett, 41 B.T.A. 700-709 (1940), affd. 118 F. 2d 644 (C.A. 1, 1941), but where the parties have agreed as to the allocation of a payment as between principal and interest, their agreement will be recognized. Huntington-Redondo Co., 36 B.T.A. 116 (1937). The rules regarding the application of payments, where more than one debt exists, are that the payment will be applied as the debtor directs but if the debtor fails to make such an application, the payment will be applied as the creditor directs. Chicago

& North Western Railway Co., 29 T.C. 989, 996 (1958) appeal dismissed (C.A. 7, 1958).

It is clear in the instant case that petitioners treated the payments received in the taxable years here involved as payments on the principal amount of the purchase price of their stock and so allocated the payments by treating the full amount of such payments on their income tax returns as receipts of the purchase price of their stock. Cf. Lincoln Storage Warehouse, 13 T.C. 33, 40 (1949), affd. 189 F. 2d 337 (C.A. 3, 1950).

If the evidence did support respondent's contention that $237,112 of the $1,300,000 was intended to be in lieu of interest, it would follow that since there was no contrary agreement between the parties petitioners would be entitled to have their allocation of the payments to principal recognized until the entire principal had been paid. This event not only did not occur in the taxable years here involved but never occurred. The facts show that the total payment received by petitioners at the conclusion of the transaction was only $936,131.85.

Respondent's own determination of the gain as set forth in the notice of deficiency recognizes petitioners' allocation of the amounts received from the Institute and is inconsistent with an allocation of any portion of the payments to interest. Respondent, accepting the method used by petitioners on their returns, computed each petitioner's gain from the transaction by treating the amount to be received for the stock as $1,175,000 which was the face amount of the note less the $125,000 attributable to the notes due to petitioner. Respond-

ent allocated the $1,175,000 to each petitioner on the basis of the percentage of stock he owned to the total stock sold. From the amount to be received by each petitioner as so determined, respondent subtracted that petitioner's basis in his stock and considered the remainder to be the net gain to be received from the transaction. Respondent then applied the percentage which the net gain as computed for each petitioner bore to the total amount to be received by that petitioner to the amount received in each year here involved to determine the taxable net gain for that year. This method of determining the amount of gain received by each petitioner in each year is based on the assumption that the entire $1,175,000 face amount of the note is the price received for the stock. To be consistent with his present contention, respondent should have considered only approximately $927,888[2] to represent the amount to be received for the stock and computed the net gains and the percentage of the payments in each year that constituted gains accordingly. The allocable portion of the interest should have been considered to constitute a separate item of income.

In support of his position respondent cites Wilshire Holding Corporation v. Commissioner, 262 F. 2d 51 (C.A. 9, 1958), reversing a Memorandum Opinion of this Court. In that case the Court of Appeals held that this Court was not precluded by a prior Circuit Court decision in the same case from determining whether under the facts there present an allocation of payments

[2] $1,175,000 minus $237,112 less whatever portion of assumed interest respondent considered applicable to the $125,000 of notes.

made to purchase real estate between principal and interest payments was appropriate. The case is not in point under the facts of the instant case. Here, the parties, themselves, have expressly provided for payment on a purchase price without a provision for interest except under circumstances which did not occur. In Wilshire Holding Corporation v. Commissioner, supra, a transaction in form a rental agreement was held in law to constitute a sale agreement. Under such circumstances the Circuit Court held that consideration could be given to whether, in fact, some portion of the payment should be considered as interest.

We hold that no part of the payments received by petitioners is allocable to interest.

Certain adjustments made by respondent are not contested by petitioners.

Reviewed by the Court.

Decision will be entered under Rule 50.

Withey, J., dissenting: I concur in the dissent of Judge Pierce. It is true that the Institute, prior to embarking upon the "sale" transaction here, made an investigation of Clay Brown & Company as though its intent was to carry out a real sale. In my view, this investigation was part and parcel of the elaborately developed bail-out plan and is nothing more than window dressing. I doubt if the 10 percent "rental" retained by the Institute was in consideration of its services rendered because I do not believe that it rendered any services. I would have held the 10 percent retention to have been in essence a gift.

Turner, J., agrees with this dissent.

Pierce, J., dissenting: The Supreme Court said in Griffiths v. Helvering, 308 U. S. 355:

> We cannot too often reiterate that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." Corliss v. Bowers, 281 U. S. 376, 378. And it makes no difference that such "command" may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency. * * *

I am impelled to dissent from the majority opinion herein, because I believe that inadequate effect was given to the foregoing principles, and that the case has been wrongly decided.

I.

The intricate series of transactions here involved is typical of a widely publicized tax avoidance plan, sometimes referred to as a "Bail-Out Plan" or a "Bootstrap Sale."[1] The objective of such a plan is to set up a procedure whereby low-basis stockholders of a close corporation which has large accumulated earned surplus and prospects for good future earnings, might "bail

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[1]Moore and Dohan, Sales, Churches, and Monkeyshines, (1956), 11 New York Univ. Tax Law Review, p. 87; Lanning Tax Erosion and the "Bootstrap Sale" of a Business, (1960), 108 U. of Penna. L. Rev., p. 623; MacCracken, Selling a Business to a Charitable Foundation, 1954 Univ. of So. Calif. Tax Inst., pp. 205, 209.

out" these earnings and future profits at less than the normal tax cost, without disruption of the continued business operations, and with the "sellers" retaining their command and control over such operations while the bail out is in process. An indispensible feature of such a plan is a purported "installment sale" of the business to a tax-exempt charitable organization, through which the plan is operated and the future tax-free business profits are "channeled" back to the "sellers"—without the charity making any investment from its own assets or assuming any personal liability.

Of course, the fact that the plan is devised for tax avoidance purposes is not alone sufficient to condemn it; but this factor does justify close scrutiny of what in reality has been done. As was recently said by the Court of Appeals for the Fifth Circuit in United States v. General Geophysical Co., (10/20/61) .... F. 2d ....:

> These tax avoidance implications do not constitute a license to courts to distort the laws or to write in new provisions; they do mean that we should guard against giving force to a purported transfer which gives off an unmistakably hollow sound when it is tapped. * * *

II.

What happened in the present case may be summarized as follows. The petitioners (consisting of Clay Brown, his wife and three children, and the two Booths—all of whom are herein referred to as the "Brown group") owned all or substantially all the issued and outstanding shares of capital stock of Clay Brown & Company, which had certain lumber interests

and operated a sawmill near Fortuna, California. The aggregate cost basis of the Brown group's investment was only about $42,000; whereas the corporation had, as of January 31, 1953, an accumulated earned surplus of $448,472, and prospects for good future earnings as its timber was utilized and the lumber was sold.

In the summer of 1952 Clay Brown, who was president of the company and also the representative of the Brown group, had a conference with a business promoter who supplied him with brochures pertaining to the bail-out plan of procedure. These brochures pointed out the hazards of heavy tax penalties on the corporation for unreasonable accumulation of surplus, the "ruinous" possible effects of estate and income taxes if the Browns' investment were retained in the business or current dividends were paid, and the advantages of using the bail-out plan to relieve such situation. The upshot was that the Brown group decided to embark on such a plan; specific details for adapting the plan to the particular situation were worked out; a complicated set of interrelated legal instruments was drafted to give effect to the plan; and then, as of February 4, 1953, the following steps were taken:

(a) The Brown group endorsed and delivered all their shares of stock of Clay Brown & Company to the charitable organization here involved (called the Institute), together with $125,000 face amount of promissory notes of said company that were then held by Clay Brown and his wife. The Institute at the same time delivered to the Brown group, as purported consideration therefor, its "promissory note" in the face amount of $1,300,-

000, which was dated to mature about 10 years later, which was nonnegotiable and noninterest bearing; with respect to which the Institute assumed no personal liability whatever for its payment; and on which payments were to be made solely out of so-called "rentals" derived from the future profits of the continuing business, in the manner more fully described. The Institute invested none of its own assets in exchange for the stock; and indeed, it had no such assets available for investment, because its receipts came principally from donations made to it for charitable purposes. Clay Brown did not even inquire regarding its assets or its financial responsibility.

(b) The Institute as "buyer" of the stock, had no discretion whatever as to what disposition it might make of the property; for all details as to such disposition were specifically arranged and provided for in the various predrafted instruments of the plan. These included the following steps which were then followed: (1) The Clay Brown Company was dissolved; (2) $5,000 of the underlying current assets were withdrawn and turned over to the Brown group as a "down payment," in order to set up a purported "installment sale" for the transferred stock; (3) the remaining net current assets were "Sold" for another promissory note to a new thinly capitalized corporation named Fortuna Mills, Inc., which had theretofore been organized in the office of Clay Brown's attorneys, for the specific purpose of taking over and continuing the operations of the former business of

Clay Brown Company; (4) all other assets of the business, both real and personal, were thereupon mortgaged back to the Brown group; and (5) these same assets were than "rented" by the Institute to the new Fortuna Company, under arrangements whereby 80 percent of the net profits of the business, before any allowances for depreciation or for state and Federal taxes, were to be distributed currently to the Institute as "rental," and whereby 90 percent thereof were then to be paid over to the Brown group as purported "credits", on the above-mentioned $1,300,000 note.

(c) Concurrently and as part of the plan, Clay Brown was employed as "general manager" for the new Fortuna Company at an annual salary of $25,000; and further provision was made that, if for any reason he ceased to act as such, his successor would be selected by the Brown group. The powers given to Brown in such capacity were substantially the same as those which he had previously exercised as president of Clay Brown & Company. No property could be sold without his consent. When mortgage loans of the Clay Brown Company were transferred into the name of the new company, Brown personally guaranteed them (for the entire capital stock of the new company was equal only to Brown's first year's salary). And Brown also, on another occasion, personally guaranteed a $50,000 bank loan to the new company.

The new Fortuna Company took over and continued operation of the business, without interruption; and it thereafter continued to operate the same for about 4½ years on the same premises, with the same operating personnel, with both the control and management thereof in the hands of Clay Brown, and with no practical difference except as to name. During said period, it harvested over 20,000,000 feet of timber from the interests which it had taken over from the Clay Brown Company; and it currently paid out its profits, before depreciation and before taxes, in the manner above described.

These operations continued until June 19, 1957, when Fortuna Mills shut down its mill and permanently discontinued business. Thereupon, an appraisal was made of the remaining net assets of the business; and this revealed the salable value of the same to be about $300,000, as compared with the appraisal made prior to the purported "sale" of over $1,000,000.

In July 1959, the entire remaining assets of the business were sold to a third party for $300,000; and out of the net proceeds, the Brown group then received 90 percent, and the Institute received its familiar 10 percent. Thereafter, in accordance with a "settlement" between the Brown group and the Institute, the $1,300,000 "promissory note" of the Institute was canceled; and also all of the "mortgages," "rental agreements," "assignments," and other instruments which had been employed under the plan, were likewise canceled.

The net financial result of the plan's operation was that the Brown group received out of its investment during the time that the plan was in operation, a total of

$936,131.85; and the Institute received nothing except its 10 percent withdrawals from the current distributions which passed through its hands. It is the above amount of over $900,000 which the Brown group has contended should be taxed at the preferred capital gain rates after spreading on the installment sale basis; and it is this amount also which the respondent determined should be taxed as ordinary income from the continued operation of the business, after adjustment for exhaustion of the Brown group's original investment.

III.

When the foregoing intricate series of transactions are viewed in the light of their realities, when consideration is given to who had the command and control over the business, who bore the risks of its operation, and who was entitled to enjoy the substantial benefits therefrom—I believe the same will not support a conclusion that the business actually was "sold" to Institute, or that the Brown group received its share of the profits solely in the capacity of "creditors" of the Institute.

Moreover, it is doubtful whether there was any legally sufficient "consideration"[2] delivered by the Institute.

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[2]See in this connection, 1 Williston on Contracts, 3d Ed. (1957), sec. 112 at p. 445. There Williston, in his discussion of consideration, gives the illustration of a man saying to a tramp: "If you go around the corner to the clothing shop there, you may purchase an overcoat on my credit." Williston says that although the walk might be regarded as a legal detriment to the tramp, yet it is not "consideration" because, on a reasonable interpretation, the walk was not requested as the price of the promise but merely as a condition of a gratuitous promise.

which would support a valid sale. It invested nothing out of its own assets; assumed no personal liability for payment of the $1,300,000 "promissory note"; and became entitled to receive only what was, in effect, a 10 percent "service fee" for its assistance in carrying out the plan. All acts done were for the primary benefit of the Brown group; and the Institute was, in reality, merely an interposed subservient agency (see quotation from Griffiths v. Helvering, supra).

In the leading case of Gregory v. Helvering, 293 U. S. 465, the Supreme Court refused to give effect to corporate transactions which complied precisely with the formal requirements for nontaxable corporate reorganizations, on the ground that the transactions had served no functions other than that of a contrivance to bail out corporate earnings to the sole shareholder at capital gains tax rates. In Commissioner v. Court Holding Co., 324 U. S. 331, the Supreme Court taxed a corporation on the gain from sale of an apartment house notwithstanding a transfer of the house to the corporation's two shareholders before the sale, since it found that the transfer was made solely to set in a more favorable tax form, a sale which in reality was made by the corporation. Similarly, in Helvering v. Clifford, 309 U. S. 331, the Supreme Court taxed a

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See also, Evans v. Rothensies, (C.A. 3) 114 F. 2d 958, wherein the taxpayer "sold" preferred stock to a penniless son-in-law, for a joint-and-survivor annuity of slightly less than the dividends. Nearly all the stock was held in escrow to secure the annuity payments. The court held that the stock transfer was "hardly more than a gift," with retention of a partial interest in the income from the stock for the lives of the "seller" and his wife.

trust grantor on the income of the trust property, since the formal transfer of the property by the grantor was lacking in substance. The Court found that the dilution of the grantor's control seemed insignificant and immaterial, and that "since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position."

See also the recent case of Knetsch v. United States, 364 U. S. 361; Emanuel N. (Manny) Kolkey, 27 T. C. 37, 57-62, affd. (C.A. 7) 254 F. 2d 51; and the recent Fifth Circuit case of United States v. General Geophysical Co., supra.

I would have held that the Brown group made no valid "sale" to the Institute of their equity interests in the business.

Turner, Raum, Withey, Atkins and Mulroney, JJ., agree with this dissent.

Tax Court of the United States

Docket No. 83795

CLAY B. BROWN and DOROTHY E. BROWN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liabilities filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

Ordered and Decided: That there are deficiencies in income taxes due from the petitioners for the taxable years 1953 and 1954 in the amounts of $1,044.94 and $122.92, respectively; and

That there is an overpayment in income tax for the taxable year 1955 in the amount of $37.85, which amount was paid on April 12, 1956, and for which amount a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of mailing of the notice of deficiency.

/s/ IRENE F. SCOTT
Judge

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioners.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83796

DONALD L. BROWN and INGRID R. BROWN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioners for the taxable year 1954 in the amount of $597.56;

That there is an overpayment in income tax for the taxable year 1955 in the amount of $21.20, which amount was paid March 28, 1956, and for which amount a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency; and

That there is an overpayment in income tax for the taxable year 1956 in the amount of $6.68, which amount was paid on April 15, 1957, and for which amount a claim for refund could have been filed, under the provisions of section 6511(b)(2) of the Internal

Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency.

/s/ IRENE F. SCOTT,
Judge.

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioners.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83797

CHARLES WILLIAM BOOTH and NANCY H. BOOTH,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, **it is**

Ordered and Decided: That there are deficiencies in income taxes due from the petitioners for the taxable years 1953 and 1955 in the amounts of $20.30 and $9.38, respectively;

That there is an overpayment in income tax for the taxable year 1954 in the amount of $5.60, which amount was paid on March 10, 1955 and for which amount a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency; and

That there is an overpayment in income tax for the taxable year 1956 in the amount of $1.41, which amount was paid April 15, 1957, and for which amount a claim for refund could have been filed, under the

provisions of section 6511(b)(2) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency.

/s/ IRENE F. SCOTT,
Judge.

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioners.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83798

DONALD LEE BROWN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioner for the taxable year 1953 in the amount of $942.48.

/s/ IRENE F. SCOTT,
Judge.

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision

entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioner.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83799

PHILIP F. BROWN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioner for the taxable year 1953 in the amount of $55.00;

That there is an overpayment in income tax for the taxable year 1954 in the amount of $1.19, which amount was paid April 15, 1955 and for which amount a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of mailing of the notice of deficiency;

That there is an overpayment in income tax for the taxable year 1955 in the amount of $22.34, which amount was paid: $11.23 on December 28, 1955 and $11.11 on April 15, 1956; and for which amounts a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code

of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency; and

That there is an overpayment in income tax for the taxable year 1956 in the amount of $6.67, which amount was paid April 15, 1957, and for which amount a claim for refund could have been filed, under the provisions of section 6511(b)(2) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency.

/s/ IRENE F. SCOTT,
Judge.

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioner.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83800

MARILYN BROWN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed December 19, 1961, and the agreed computation of the tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioner for the taxable year 1953 in the amount of $55.00;

That there is no deficiency in income tax due from, or overpayment due to, the petitioner for the taxable year 1954;

That there is an overpayment in income tax for the taxable year 1955 in the amount of $22.34, which amount was paid: $0.39 on December 28, 1955 and $21.95 on April 12, 1956; and for which amounts a claim for refund could have been filed, under the provisions of section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency; and

That there is an overpayment in income tax for the taxable year 1956 in the amount of $6.67, which amount

was paid December 28, 1956, and for which amount a claim for refund could have been filed, under the provisions of section 6511(b)(2) of the Internal Revenue Code of 1954, on July 30, 1959, the date of the mailing of the notice of deficiency.

/s/ IRENE F. SCOTT,
Judge

* * * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,
Attorney for Petitioner.

/s/ CRANE C. HAUSER,
Chief Counsel,
Internal Revenue Service

/s/ WILLIAM H. KINSEY,
Attorney for Petitioner.

[Seal]

Entered April 3, 1962.

Served April 3, 1962.

Tax Court of the United States

Docket No. 83795

CLAY B. BROWN and DOROTHY E. BROWN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 83796

DONALD L. BROWN and INGRID R. BROWN,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 83797

CHARLES WILLIAM BOOTH and NANCY H. BOOTH,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 83798

DONALD LEE BROWN,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 83799

PHILIP F. BROWN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 83800

MARILYN BROWN,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It is hereby stipulated and agreed between the Commissioner of Internal Revenue and the above-named taxpayers by their respective undersigned attorneys, that the following facts shall be taken as true, provided, however, that this stipulation does not waive the right of either party to introduce other evidence not at variance to the facts herein stipulated, or to object to the introduction in evidence of any such facts on the of immateriality or irrelevancy.

1. Petitioners, Clay B. Brown and Dorothy E. Brown, Docket 83795, are husband and wife residing in Portland, Oregon. During the calendar years 1953, 1954 and 1955 petitioners filed Federal individual joint income tax returns with the District Director of In-

ternal Revenue for the District of Oregon. Attached hereto, marked Exhibits 1-A, 2-B and 3-C, respectively, are photostatic copies of petitioners' income tax returns for the calendar years 1953, 1954 and 1955.

2. Petitioners, Donald L. Brown and Ingrid R. Brown, Docket 83796, are husband and wife now residing in Portland, Oregon. During the calendar years 1954, 1955 and 1956 petitioners filed Federal individual joint income tax returns with the District Director of Internal Revenue for the District of California at San Francisco. Attached hereto, marked Exhibits 4-D, titioners' income tax returns for the calendar years 1954, 5-E and 6-F, respectively, are photostatic copies of pe-1955 and 1956.

3. Petitioners, Charles William Booth and Nancy H. Booth, Docket 83797, are husband and wife residing in Milwaukie, Oregon. During the calendar years 1953, 1954, 1955 and 1956 petitioners filed Federal individual joint income tax returns with the District Director of Internal Revenue for the District of Oregon. Attached hereto, marked Exhibits 7-G, 8-H, 9-I and 10-J, respectively, are photostatic copies of petitioners' income tax returns for the calendar years 1953, 1954, 1955 and 1956.

4. Petitioner, Donald Lee Brown, Docket 83798, now resides in Portland, Oregon with the wife, Ingrid R. Brown. During the calendar year 1953 petitioner

filed his Federal individual income tax return with the District Director of Internal Revenue for the District of California at San Francisco. Attached hereto, marked Exhibit 11-K, is a photostatic copy of petitioner's income tax return for the calendar year 1953.

5. Petitioner, Philip F. Brown, Docket 83799, is an individual residing in Portland, Oregon. During the years 1953, 1954, 1955 and 1956 petitioner filed Federal individual income tax returns with the District Director of Internal Revenue for the District of Oregon. Attached hereto, marked Exhibits 12-L, 13-M, 14-N and 15-O, respectively, are photostatic copies of petitioner's income tax returns for the calendar years 1953, 1954, 1955 and 1956.

6. Petitioner, Marilyn Brown, Docket 83800, is an individual residing in Portland, Oregon. During the calendar years 1953, 1954, 1955 and 1956 petitioner filed Federal individual income tax returns with the District Director of Internal Revenue for the District of Oregon. Attached hereto, marked Exhibits 16-P, 17-Q, 18-R and 19-S, respectively, are photostatic copies of petitioner's income tax returns for the calendar years 1953, 1954, 1955 and 1956.

7. Notices of deficiencies (copies of which are attached to the petitions in these cases and made a part hereof by this reference) were mailed to the above-described petitioners on July 30, 1959. On said notices

respondent determined deficiencies in income tax for the taxable years as follows:

Docket No.	Calendar Year	Petitioner	Deficiency
83795	1953	Clay B. Brown, et ux.	$ 2,732.62
	1954		5,073.80
	1955		50,779.14
83796	1954	Donald L. Brown, et ux.	2,080.04
	1955		16,621.28
	1956		5,815.76
83797	1953	Charles W. Booth, et ux.	79.74
	1954		231.66
	1955		2,005.41
	1956		840.97
83798	1953	Donald L. Brown	1,445.28
83799	1953	Philip F. Brown	260.00
	1954		1,042.61
	1955		18,462.71
	1956		6,639.80
83800	1953	Marilyn Brown	260.00
	1954		1,003.39
	1955		18,465.66
	1956		6,590.81

8. Clay Brown & Company, at all times herein pertinent (until its dissolution as hereinafter related) was an Oregon corporation qualified to do business in California, having an authorized capital stock of 50,000 shares, par value $1.00 per share. References made in this stipulation to the "corporation" means Clay Brown & Company. The certificate evidencing the filing of the articles of incorporation issued by the Oregon Corporation Commissioner on September 28, 1946 is hereto attached as Exhibit 20-T. After its incorporation and prior to 1949 Clay Brown & Company was engaged in the forest production sales business at wholesale. In 1949 the corporation acquired millsite property at Fortuna, California and constructed thereon a gang mill and planing mill with substantially all new

equipment. The gang mill and planing mill were put into operation during February 1950. In the spring of 1951 the corporation completed an additional unit consisting of a circle sawmill which was converted into a band sawmill during the fall of 1951. Such installation was primarily new equipment except for the band headrig which was acquired used. The output of the gang sawmill, band sawmill and planing mill was sold through the sales and executive office of the corporation maintained in 1111 U. S. National Bank Building, Portland, Oregon. The corporation also maintained a sales office in San Francisco.

9. Clay Brown and Company, Inc. had authorized capital stock (par value one dollar per share) of fifty-thousand shares. Thirty-two thousand shares were issued and outstanding as follows:

Name	Acquired	Number of Shares	Cost	Clay Brown & Co. Official Title
Clay B. Brown*	9-30-46	6,000	$6,000.00	President
Dorothy E. Brown*	"	6,000	6,000.00	None
Donald L. Brown	"	6,000	6,000.00	Ass't. Vice Pres.
Philip F. Brown	"	6,000	6,000.00	None
Marilyn Brown	"	6,000	6,000.00	None
Charles W. Booth	12-50	1,000	7,993.00	Secretary-Treasurer
Nancy H. Booth	4-52	500	4,000.00	None
C. A. Hill**		500	**	Vice President

*Parents of Donald L., Philip F. and Marilyn Brown.
**C. A. Hill is not a party to these proceedings.

10. Attached hereto, marked Exhibits 21-U and 22-V, respectively, are photostatic copies of the Federal corporation income tax returns of Clay Brown and Company, Inc. for the fiscal year ended April 30, 1952 and the short period ended January 31, 1953.

11. In October or November 1952, William B. Boone of the Portland, Oregon office of Dean Witter & Co., investment counselors and brokers, met Clay Brown

and brought him together with Louis H. Seagrave who was then the Chairman of the board of directors of California Institute for Cancer Research. A copy of a letter dated November 28, 1952 from William B. Boone to Louis H. Seagrave is hereto attached and marked Ex. 23-W.

12. Attached hereto, marked Ex. 24-X, are copies of circulars received by Mr. Boone of Dean Witter & Co. from Mr. Seagrave.

13. Two letters dated December 17, 1952 from Seagrave to Clay Brown & Company are attached hereto marked Exs. 25-Y and 26-Z, respectively.

14. Copies of the replies to the letters identified in paragraph 13, above, being a letter dated December 22, 1952 and a letter dated December 23, 1952 to Louis H. Seagrave signed by C. W. Booth, are attached hereto and marked Exs. 27-AA and 28-BB, respectively. The letter dated December 22, 1952 (Ex. 27-AA) makes reference to a statement prepared by Peat, Marwick, Mitchell & Co. dated April 30, 1952, and the original of such Peat, Marwick, Mitchell & Co. statement is attached hereto and marked Ex. 29-CC. Atatched to Ex. 27-AA is the letter Seagrave to Booth dated January 7, 1953.

16. Attached hereto and marked Ex. 30-DD are the introduction pages, index and 16 recapitulation pages of the appraisement of Clay Brown & Company made by General Appraisal Company dated July 21, 1951.

17. Attached hereto, marked Ex. 31-EE, is the appraisement of Clay Brown & Company made by General Appraisal Company dated January 14, 1953 supplementing the appraisal of July 21, 1951.

18. Attached hereto, marked as Ex. 32-FF, is a document entitled "Purchase Agreement" and dated February 4, 1953.

19. The stock record book of Clay Brown and Company reflects issuance of the stock as hereinbefore set forth, the cancellation of such shares of stock as of February 4, 1953, the issuance of a certificate in the amount of 32,000 shares to the California Institute for Cancer Research, Certificate No. 18, dated February 4, 1953 which certificate bears the following typed legend:

> "Cancelled March 14, 1953 upon complete liquidation of the corporation pursuant to resolutions adopted by stockholders and directors on February 4, 1953."

and the endorsement dated March 13, 1953 of the California Institute for Cancer Research as follows: "Certificate being returned for cancellation".

20. The following exhibits relate to the "liquidation" of Clay Brown and Company referred to in the certificate mentioned in the preceding paragraph:

Minutes of special meeting of the Board of Directors of Clay Brown and Company held on February 4, 1953, the original of which minutes are hereto attached as Ex. 33-GG.

Minutes of special meeting of the stockholders of Clay Brown and Company held on February 4, 1953, the original of which minutes are hereto attached as Ex. 34-HH. Attached to Ex. 34-HH is a waiver of notice for stockholders, a proxy to Louis H. Seagrave and a certified copy of reso-

lutions of the California Institute for Cancer Research.

(Mr. Sabin and Mr. Simmons are or were attorneys in the office of Wilbur, Mautz, Souther & Spaulding, Portland, Oregon (now Mautz, Souther, Spaulding, Kinsey and Williamson).)

Minutes of special meeting of the Board of Directors of Clay Brown and Company held on February 4, 1953, the original of said minutes being hereto attached as Ex. 35-II.

Certificate and copies of resolutions dissolving the corporation executed on behalf of Clay Brown and Company and filed with the Oregon Corporation Commissioner are hereto attached as Ex. 36-JJ.

Grant deed dated February 4, 1953 from Clay Brown and Company to California Institute for Cancer Research, a copy of which is hereto attached as Ex. 37-KK.

Bill of sale dated February 4, 1953 from Clay Brown and Company to California Institute for Cancer Research, a copy of which is hereto attached as Ex. 38-LL.

General assignment dated February 4, 1953 from Clay Brown and Company to California Institute for Cancer Research, a copy of which is hereto attached as Ex. 39-MM.

Copy of title report of Belcher Abstract and Title Co. of Eureka, California, a copy of which is hereto attached as Ex. 40-NN.

U. S. Treasury Department Forms 1099-L and 966 filed by or on behalf of Clay Brown and

Company, copies of which forms are hereto attached as Exs. 41-OO and 42-PP.

A copy of the minutes of Clay Brown and Company immediately preceding the minutes of February 4, 1953 is hereto attached as Ex. 43-QQ. Prior to minutes of Clay Brown and Company dated February 4, 1953 the minute book of Clay Brown and Company contains no minutes relating to the transaction with the California Institute for Cancer Research.

21. The California Institute for Cancer Research issued a nonnegotiable, non-interest bearing promissory note in the amount of $1,300,000.00, dated February 4, 1953, payable to Clay Brown, et al. A copy of the note is attached hereto as Ex. 44-RR and said note is hereinafter referred to as the "promissory note". The promissory note referred to the following:

Deed of trust dated February 4, 1953, between the California Institute for Cancer Research as trustor, Belcher Abstract & Title Company as trustee, and Clay Brown, et al., as beneficiary, a copy of which deed of trust is hereto attached as Exhibit 45-SS.

Chattel mortgage dated February 4, 1953 from the California Institute for Cancer Research as mortgagor to Clay Brown, et al., as mortgagees, the executed original of which is hereto attached marked Ex. 46-TT.

A security document not referred to in the promissory note was a general assignment dated February 4, 1953 from the California Institute for Cancer Research to

Clay Brown, et al., the executed original of which is hereto attached marked Ex. 47-UU. As indicated in the letter dated March 12, 1953 from Belcher Abstract & Title Company to Wilbur, Mautz, Souther & Spaulding, the original of which is hereto attached marked Ex. 48-VV, the deed dated February 14, 1953 (Ex. 37-KK), the deed of trust dated February 4, 1953 (Ex. 45-SS), and the chattel mortgage dated February 4, 1953 (Ex. 46-TT) were recorded on March 12, 1953.

22. Fortuna Sawmills, Inc. is a California corporation incorporated on January 26, 1953 having authorized capital stock of 2500 shares, par value $10.00 per share. All of said shares were issued and outstanding, and were owned 2,000 shares by Calvin N. Souther and 500 shares by William H. Kinsey. The officers and directors of Fortuna Sawmills, Inc. were:

Calvin N. Souther	President and Director
Raymond P. Underwood*	Vice President and Director
William H. Kinsey	Secretary and Director

*Mr. Underwood is a member of the same legal firm as Mr. Souther and Mr. Kinsey, the present name of the firm being Mautz, Souther, Spaulding, Kinsey and Williamson.

23. Fortuna Sawmills, Inc. was a party to the following:

Lease and license agreement dated February 4, 1953 between the California Institute for Cancer Research as lessor, and Fortuna Sawmills, Inc. as lessee, the executed original of said lease being hereto attached as Ex. 49-WW.

General assignment dated February 4, 1953 from the California Institute for Cancer Research to

Fortuna Sawmills, Inc., a copy of which is hereto attached as Ex. 50-XX.

Assumption agreement of Fortuna Sawmills, Inc., dated February 4, 1953, a signed counterpart of which is hereto attached as Ex. 51-YY.

Promissory note of Fortuna Sawmills, Inc. dated May 15, 1953 in the amount of $20,999.79, a copy of which is hereto attached as Ex. 52-ZZ.

24. Attached hereto and marked Ex. 53-AAA are copies of all pages of Fortuna Sawmills, Inc.'s minute book except those indicating reelection of members of the board and officers.

25. The Clay Brown & Co. transaction is referred to in the following minutes of two meetings of the Board of Directors of California Institute for Cancer Research:

Minutes of the meeting of the Board of Directors held on January 6, 1953, a copy of these minutes being hereto attached marked Ex. 54-BBB, together with the documents referred to therein contained in the Institute minute book following the minutes of the meeting.

Minutes of the meeting of the Board of Directors held on January 27, 1953, a copy of these minutes being hereto attached marked Ex. 55-CCC, together with the documents referred to therein contained in the Institute minute book following the minutes of the meeting.

26. The assets of Clay Brown & Co. were subject to a mortgage to the United States National Bank of Portland, Oregon, in participation with the Reconstruction

Finance Corporation. The bank and the R. F. C. consented to the transfer of the property by Clay Brown & Co. upon its liquidation to the California Institute for Cancer Research. An executed copy of such consent and assumption agreement of Fortuna Sawmills, Inc., is hereto attached as Ex. 56-DDD.

27. Attached hereto marked Ex. 57-EEE is letter dated November 3, 1954, from William H. Kinsey to Clay Brown. A copy of this letter is included as an exhibit at the request of respondent, such copy having been taken by respondent from the records of the California Institute for Cancer Research subpoenaed by respondent. This letter of November 3, 1954, on page 2 quotes from an eleven page opinion of Wilbur, Mautz, Souther & Spaulding, attorneys. In response to the request of respondent, a copy of this memo, Ex. 58-FFF, has been supplied by said attorneys, said memo being one of the copies thereof in the files of said attorneys contained in a flat folder entitled "Preliminary Drafts and Related Matters". Attached hereto as exhibits are the following related correspondence and file:

Copy of letter dated November 5, 1954 from Clay Brown to Paul K. Yost, Executive Vice President of California Institute for Cancer Research, enclosing in duplicate the above-mentioned letter of November 3, 1954, a copy of which letter is hereto attached, marked Ex. 59-GGG.

Copy of letter dated November 30, 1954 from Clay Brown to Paul K. Yost, Executive Vice President of California Institute for Cancer Research, a copy of which is hereto attached marked Ex. 60-HHH.

Letter dated February 24, 1955 from William H. Kinsey to Arthur A. Armstrong making reference to the proposal contained in his letter of November 3, 1954 to Clay Brown, a copy of which letter is hereto attached marked Ex. 61-III.

Contents from flat folder entitled "Preliminary Drafts and Related Matters" in files of Wilbur, Mautz, Souther & Spaulding (now Mautz, Souther, Spaulding, Kinsey & Williamson) are attached hereto as Ex. 62-JJJ.

28. Attached hereto as Exs. 63-KKK and 64-LLL, respectively, are photostatic copies of the Federal corporation income tax returns of Fortuna Sawmills, Inc. for the short period February 1, 1953 to April 30, 1953 and the fiscal year ended April 30, 1954.

29. The Cancer Research Foundation of California was formed as a nonprofit, non-stock corporation on April 26, 1945, under the provisions of Division 1, Part 4, Title 12. Article 1 of the Civil Code for such scientific, charitable and educational purposes as are set forth in its Articles of Incorporation. On August 25, 1947, its name was changed to California Institute for Cancer Research. On February 25, 1957, the name was changed to West Los Angeles Institute for Cancer Research.

30. The sawmill and planing mill operations of Fortuna Sawmills, Inc. were shut down and discontinued on or about June 19, 1957, and the lease between the California Institute and Fortuna Sawmills, Inc., expired on January 31, 1958. Correspondence (three letters) relating to the shut down of the mill and the delivery

of possession upon termination of the lease is attached hereto, as Ex. 65-MMM, more particularly described as follows:

> Letter dated June 21, 1957 from Calvin N. Souther, President of Fortuna Sawmills, Inc. to Clay Brown.
>
> Letter dated July 9, 1957 from Clay Brown to George Castera, President of West Los Angeles Institute for Cancer Research.
>
> Letter dated December 6, 1957 from Calvin N. Souther, President of Fortuna Sawmills, Inc. to West Los Angeles Institute for Cancer Research.

Further correspondence is attached hereto, marked and described as follows:

> Letter dated January 10, 1958 from Clay Brown to Calvin N. Souther, President, Fortuna Sawmills, Inc., the original of which is hereto attached marked Ex. 66-NNN.
>
> Letter dated January 20, 1958 from Clay Brown to Calvin N. Souther, President of Fortuna Sawmills, Inc. and to William H. Kinsey, the original of which is hereto attached marked Ex. 67-OOO, together with copies of the following referred to therein:
>
> Letter dated January 17, 1958 from West Los Angeles Institute for Cancer Research to Clay Brown, individual representative of the sellers of the stock of Clay Brown & Co. and to Fortuna Sawmills, Inc.; Letter dated January 9, 1957, from George Castera to Clay Brown; Letter dated December 20, 1956, from Fortuna Sawmills,

Inc. to George Castera, President of California Institute of Cancer Research.

Letter dated January 29, 1958 from Fortuna Sawmills, Inc., signed by William H. Kinsey, to George Castera, President West Los Angeles Institute for Cancer Research, a copy of which is hereto attached marked Ex. 68-PPP.

Letter dated January 31, 1958 from Calvin N. Souther to Clay Brown, a copy of which is hereto attached marked Ex. 69-QQQ.

Letter dated February 1, 1958 from Clay Brown to Calvin N. Souther, a copy of which is hereto attached marked Ex. 70-RRR.

Letter dated February 14, 1958 from Calvin N. Souther, President of Fortuna Sawmills, Inc. to Clay Brown, a copy of which is hereto attached and marked Ex. 71-SSS.

Letter dated February 14, 1958 from Calvin N. Souther, President of Fortuna Sawmills, Inc. to West Los Angeles Institute for Cancer Research, a copy of which is hereto attached and marked Ex. 72-TTT.

31. A schedule is attached to this stipulation summarizing the net profit or loss made by Fortuna Sawmills, Inc. during its operations, the payments made by Fortuna Sawmills, Inc. to California Institute for Cancer Research under the Lease and License Agreement, and payments made by the California Institute for Cancer Research for application upon the promissory note. The schedule is marked Ex. 73-UUU.

32. A copy of an agreement, dated June 3, 1958, as of February 1, 1958, by and between West Los Angeles

Institute for Cancer Research, formerly California Institute for Cancer Research, and Clay Brown, Dorothy E. Brown, Donald Brown, Philip Brown, Marilyn Brown, C. A. Hill, Nancy H. Booth and C. W. Booth, is attached hereto as Ex. 74-VVV.

33. In July 1959, the property subject to the deed of trust and chattel mortgage was acquired by the Division of Highways, State of California, for $300,000.00 as a result of threatened condemnation proceedings. Such acquisition and the distribution of proceeds therefrom, is reflected in the following:

Escrow instructions to Belcher Abstract & Title Company dated May 15, 1959, a copy of which are hereto attached as Exhibit 75-WWW.

Letter dated June 18, 1959 from Belcher Abstract & Title Company requesting that the original note and deed of trust be surrendered to Belcher Abstract & Title Company for cancellation, the original of which is hereto attached as Ex. 76-XXX.

Letter dated June 19, 1959 from C. W. Booth to Belcher Abstract & Title Company enclosing the original deed of trust and promissory note, a copy of which is hereto attached as Ex. 77-YYY.

Satisfaction of chattel mortgage showing the recording thereof, the original of which is hereto attached as Ex. 78-ZZZ.

Letter dated July 7, 1959 from Belcher Abstract & Title Company, enclosing check for $8,765.48 to Clay Brown & Company, and a check for $262,096.49 to Clay Brown and statement showing disbursement of funds, marked Ex. 79-AAAA.

Statement dated July 7, 1959 of Belcher Abstract & Title Company to West Los Angeles Institute for Cancer Research showing disposition of the $300,000 received from the Division of Highways, State of California, attached as Ex. 80-BBBB.

Statement of Clay Brown & Company to West Los Angeles Institute for Cancer Research substantiating the $8,765.48.

34. The promissory note was surrendered to Belcher Abstract & Title Company and cancelled in connection with the acquisition of the property by the Division of Highways, State of California.

35. May 1, 1952 letter from H. E. Reardon setting $9 per M stumpage value on timber, the original of which is hereto attached as Ex. 81-CCCC.

36. Peat, Marwick, Mitchell & Co. audit of January 31, 1953, hereto attached as Ex. 82-DDDD.

37. Photostatic copies of documents, clippings and correspondence from the files of the West Los Angeles Institute for Cancer Research (formerly California In-

stitute for Cancer Research) are attached hereto, described and marked as exhibits as follows:

Item	Date	Exhibit No.
Letter	February 26, 1953	83-EEEE
2 letters	January 7, 1953	84-FFFF
List	January 22, 1953	85-GGGG
Letter	January 26, 1953	86-HHHH
Letter	February 21, 1953	87-IIII
Letter	March 31, 1953	88-JJJJ
Letter	April 20, 1953	89-KKKK
Letter	May 1, 1953	90-LLLL
Letter	May 6, 1953	91-MMMM
Letter	January 12, 1954	92-NNNN
Letter	June 22, 1954	93-OOOO
Letter	November 5, 1954	94-PPPP
Letter	November 24, 1954	95-QQQQ
Letter	November 30, 1954	96-RRRR
Schedule	April 30, 1955	97-SSSS
Letter	August 9, 1955	98-TTTT
Letter	November 23, 1955	99-UUUU
Clipping	December 23, 1955	100-VVVV
Letter	March 13, 1956	101-WWWW
Letter	December 12, 1957	102-XXXX
Letter	January 30, 1958	103-YYYY
Minutes	Various, 1958	104-ZZZZ

38. Insofar as this stipulation of facts utilizes joint exhibits numbers as well as certain descriptive titles

of the various documents, instruments and correspondence attached and referred to herein as pertaining to or underlying the transaction here involved, such utilization has been for the convenience of the parties and respondent in nowise concedes the true nature of substance of the transaction in issue is governed thereby.

39. In the interest of complying with rules of the Court, the parties hereto have stipulated all documentary evidence deemed necessary to the record herein. Accordingly, the parties hereby agree that the right of cross-examination of witnesses shall not be limited by the scope of direct examination into the facts of the transaction, rather each party may extend his cross-examination to the witnesses' knowledge of the transaction here involved.

/s/ WILLIAM H. KINSEY
Counsel for Petitioners

/s/ R. P. HERTZOG
Acting Chief Counsel
Internal Revenue Service

Filed Jan. 25, 1961.

In the United States Court of Appeals
For the Ninth Circuit

T. C. Docket No. 83795

COMMISSIONER OF INTERNAL REVENUE,
Petitioner on Review,

v.

CLAY B. BROWN and DOROTHY E. BROWN,
Respondents on Review.

PETITION FOR REVIEW

To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

Comes now the Commissioner of Internal Revenue, by and through his undersigned counsel, and petitions this Honorable Court to review the decision of the Tax Court of the United States entered herein on April 3, 1962, pursuant to its opinion filed December 19, 1961 (37 T. C.—No. 50) in the consolidated proceedings of the respondents on review and five related taxpayers (in respect of whom separate petitions for review are being simultaneously filed herein), ordering and deciding "That there are deficiencies in income taxes due from the petitioners for the taxable years 1953 and 1954 in the amounts of $1,044.94 and $122.92, respectively; and that there is an overpayment in income tax for the taxable year 1955 in the amount of $37.85, which amount was paid on April 12, 1956, and for which amount a claim for refund could have been filed, under the provisions of Section 6511(c) of the Internal Revenue Code of 1954, on July 30, 1959, the date of mailing of the notice of deficiency."

Jurisdiction and Venue

This petition for review is filed pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954 and applicable amendments thereto.

The respondents on review, Clay B. Brown and Dorothy E. Brown, were husband and wife, residing in Portland, Oregon, during the years involved herein, and filed joint federal income tax returns for the years 1953, 1954 and 1955 with the District Director of Internal Revenue for the district of Oregon, whose office is located at Portland, within the jurisdiction and venue of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

Nature of Controversy

The principal issue presented for review is: Where pursuant to a prearranged plan, the respondents on review and others transferred their stock in a corporation engaged in the sale of forest products together with two promissory notes totaling $125,000 to an exempt institution for a so-called non-interest note secured by a mortgage and the latter leased the assets of the corporation to a new corporation organized by respondent's lawyers for a period of five years, and it was agreed to pay the principal of the note out of the rents received from the new corporation and the respondent-husband was employed by the new corporation to manage it and to lend their credit to it, did the Tax Court properly hold that the transaction constituted a bona fide sale of the stock, a capital asset, to the institution in return for its note and the gain realized

is taxable as a long-term capital gain within the meaning of Sections 117(a) and 1222(3) of the Internal Revenue Codes of 1939 and 1954, respectively.

In the alternate, if the gain is taxable as long-term capital gain, is any portion of the amounts received by the respondents on review in each of the years involved in payment of interest and taxable to them as "interest" income under Sections 22(a) and 61(a) of the Internal Revenue Codes of 1939 and 1954, respectively.

The majority of the Tax Court concluded that the agreement entered into between all the members of the so-called "Brown Group" and the institute on February 4, 1953, constituted a bona fide sale of their stock in Clay Brown & Company to the institute for a price arrived at in an arms-length transaction and that the amounts received from the institute are proceeds from the sale of their stock; that the note given for the stock was without interest until maturity and that arriving at the sales price of the stock no consideration was given by the parties in their negotiations to an amount in lieu of interest.

Six judges dissented from the majority opinion of the Tax Court and considered the intricate series of transactions here involved was a mere tax avoidance plan without substance or reality resulting in no valid sale of the stock or that the "Brown Group" received its share of the profits solely in the capacity of "creditors" of the institute.

What happened in the present case was summarized in a dissenting opinion of Judge Pierce on pages 33

34 and 35 of a slip opinion filed herein. Succinctly, the transaction in this proceeding involves the now familiar "bail-out sale" of capital stock in a going business to a valid tax exempt cancer research institution, (hereinafter described as "institute"), the "purchase price payments" (90% of profits) to be paid by a newly incorporated feeder company from future earnings as "rent" for operating assets (80% of profits before depreciation and taxes), which "rent" is siphoned through the institute to taxpayers. The feeder company retains 20% of the profits for its participation and the institute received 10% of the "rental payment". The taxpayers retain administrative control of the business through management contracts and power to appoint successor executives. The taxpayers' attorneys purchased the capital stock of the new feeder company and all operating assets are burdened with security devices in taxpayers' favor. The institute assumes no risks whatsoever. The avowed object of the plan is to "bail-out" retained earnings and future profits at capital gain rather than ordinary income tax rates. In the instant case, the institute's resources were committed to cancer research, not acquisition of a lumber-milling business in which it had no personnel to manage. It acted as a mere conduit, for which service it received what may properly be termed a fee.

It is submitted that a review of the transactions involved herein, in the light of their realities, when consideration is given to the person who had command and control over the business, who bore the risks of its operation and who was entitled to enjoy the substantial benefits therefrom, will reveal that the business was

not actually "sold" to a nontaxable institute and that there is not sufficient evidence of record to sustain the holdings of the majority opinion, and accordingly such holdings and conclusions of the majority should be reversed and the Commissioner's position taken herein should be upheld; to wit — that the purported purchase price payments are not entitled to capital gain treatment as a matter of law due to taxpayers' retention of economic interest in and control over the property. Viewing the record as a whole, the majority's ultimate finding with respect to the substance of the transaction is clearly erroneous.

It is also presented that the majority erred in finding that the transactions here were "arms-length" and "bona-fide". The essential nature of the transaction in the instant case was not an installment sale of the stock to the institute, but a joint venture by the taxpayers (Brown), the institute and the lawyer-organized new corporation (Fortuna) to share the earnings of the lumber business for the mutual benefit of all, and therefore the Tax Court erred in holding that the substance of the transactions was a bona-fide sale of the stock resulting in a long-term capital gain.

It is, therefore, presented that the views set forth in the dissenting opinions are correct and should be followed by this Honorable Court on review.

The Commissioner further presents in the alternate that upon the record here, the parties to the transaction intended the sum of $237,112 of the note given to be "interest". The Tax Court's finding that the record does not support this conclusion is clearly erroneous.

Statement of Points

The statement of points to be relied upon will be filed at a later date as provided by the Rules of this Court.

Wherefore, it is prayed that the errors complained of herein be reviewed and corrected and that the decision of the Tax Court be reversed.

/s/ LOUIS F. OBERDORFER,
Assistant Attorney General

/s/ CRANE C. HAUSER
Chief Counsel
Internal Revenue Service,
Counsel for the Commissioner of
Internal Revenue.

[Representative of all Petitions for Review.]

Filed June 25, 1962 (USTC).

Tax Court of the United States
Washington

Docket Nos. 83795, 83796, 83797, 83798, 83799, 83800.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILIP F. BROWN, MARILYN BROWN,
Respondents.

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the documents submitted under this certificate, 1 to 53, inclusive, as called for by the designation, and the rules, are the original documents of record on file in my office, excepting the original exhibits which are separately certified, and a true copy of the docket entries as they appear in the official docket of my office, in the cases docketed at the above numbers, in which the respondent in this Court filed petitions for review.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 10th day of September, 1962.

[Seal]

/s/ HOWARD P. LOCKE,
Clerk of the Court.

121 BEFORE THE TAX COURT OF THE UNITED STATES

Dockets Nos. 83795 through 83800

CLAY B. BROWN AND DOROTHY E. BROWN, et al., *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Transcript of Hearing—January 25, 1961

U. S. Court of Appeals
U. S. Courthouse (New)
Portland, Oregon

(Met, pursuant to notice, at 2:00 o'clock p.m.)

BEFORE:

Hon. IRENE SCOTT, Judge.

Appearances:

WILLIAM H. KINSEY, Esq. and JAMES R. MOORE, Esq. Board of Trade Building, Portland, Oregon; appearing for Petitioners.

NORMAN H. MCNEIL, Esq. and AARON S. RESNICK, Esq. 484 Pittock Block, Portland, Oregon; appearing for Respondent.

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122 WILLIAM B. BOONE was called as a witness by and on behalf of Petitioners and, having been first duly sworn, testified as follows:

The Clerk: For the record, may we have your name and address?

The Witness: William B. Boone.

The Clerk: How do you spell your last name?

The Witness: B-double o-n-e.

The Clerk: And your home address?

The Witness: 2432 S. W. Broadway Drive, Portland, Oregon.

Direct Examination

By Mr. Kinsey:

Q. What is your occupation, Mr. Boone? A. I am the resident partner and manager of Dean Witter & Company.

Q. And what is the business—(interrupted) A. We are in the investment business. Members, New York Stock Exchange and general investment bankers.

Q. In 1952, did you have any contact with Mr. Clay
123 Brown? A. I did.

Q. Would you explain the nature and circumstances of that contact? A. In the summer of 1952, Mr. George Vanderhoff (phonetic), one of my partners in our Beverly Hills office was here visiting. He stated to me that Mr. Guy Witter, in our Los Angeles office was in touch with a source of funds that was interested in acquiring and buying small companies. Subsequent to that, having inquired of a number of people, and I have known Clay Brown for a good number of years—about fifteen years—I was in contact with Clay and I stated to him, would he have any possible interest in selling his company; and in turn, he stated that not particularly. He wasn't anxious to sell it and what did I have in mind. Well, I said, "I don't know, there is some possibility—would it come about?" I notice in going through my file that on August the 8th of 1952, I wrote a letter to Mr. Guy Witter, of my Los Angeles office, and stipulating that in general on a confidential basis, there may be some possibility of Clay Brown & Company being acquired.

Mr. Resnick: Do you have that letter, Mr. Boone?

The Witness: Yes, I do.

(Letter produced and handed)

A. Following the first letter that the attorney had just taken, Mr. Guy Witter responded and stated to the fact that the parties that he was—thought might be inter-
124 ested were not interested and subsequent to that time, he did come back again and say that the Cancer Research of Los Angeles, he felt would be interested in acquiring Clay Brown & Company. At that time, Mr. Seagrave, who represented the Cancer Institute came to Portland one day, and I contacted the Clay Brown & Company office and found that Mr. Brown was not in town; made arrangement at a later time, which I have detailed wires in here expediting the meeting of Mr. Seagrave and Mr. Clay Brown in Eureka, California. And that was the time when the begining negotiations started.

Q. Did you participate in the negotiations? A. Only to the degree that—of fitting in round numbers, not the actual negotiations, in the original part. I certainly did participate in the final negotiations when Mr. Seagrave came back and I spent all day with Mr. Seagrave, Mr. Brown, Mr. Booth and I believe Mr. Souther in trying to come to a final conclusion, but as far as the preliminary facts are concerned, I did not.

Q. In your participation in the negotiations, were you aware of any negotiation relative to price? A. Well, obviously there was quite a little negotiation on this matter of fact what the price—what the offering of the stock was, what the price was on that scale.

Q. Was the main subject in the negotiations
125 price? A. I think there was definitely a consideration of price in negotiations in the begining. I mean, if there hadn't been a certain price that had been gained, I am certain that Mr. Brown would not have been interested in selling it.

Q. But the actual agreement on the price and the finalization in the negotiations was handled directly by Mr. Seagrave and Mr. Brown after you introduced them, is that correct? A. There were negotiations carried on consistently which I was not in presence. As far as their figure that finally in the final conclusion they came down and had a substantial spread, as I remember, of about a hundred and fifty thousand dollars difference between what Mr. Seagrave felt this company was worth and Mr. Brown—what Mr. Brown—it was two hundred thousand. I remember it roughly. You have all the facts there. It seems to me it was a million three and a million five. As far as getting together and making any conclusions—as a matter of fact, I was confident that one time, the whole situation had been completely dissolved, that we were not going to be able to conclude the deal.

Mr. Resnick: I move that the last remark be stricken as not responsive to the question and merely an observation, not a statement of fact.

The Court: The motion is denied.

Mr. Kinsey: That's all I have of this witness.

Cross Examination

126 By Mr. Resnick:

Q. Mr. Boone, do you have your files? A. Yes, I have.

Q. May I see them? A. You certainly may. These are the same ones you saw yesterday.

(Documents produced)

Q. At the time that you met with Mr. Seagrave of the Cancer Institute, he left with you, certain brochures and information with reference to the sale or transactions involving disposition of businesses to the Institute? A. Yes, he did. I think you took those out of the file yesterday, sir.

Q. Did you discuss the substance of those documents with Mr. Brown? A. At that point, I probably—I must have.

Mr. Resnick: The brochures we refer to, your Honor, are part of the stipulation Exhibit 24-X.

Q. Did you write a note to Mr. Brown and forward copies of some of those schedules to him for his review and consideration? A. Well, I think there is one letter there that you have—what schedule are you referring to? I'm not—(interrupted)

Q. The schedules I refer to are the various docu-
127 ments and statements that Mr. Seagrave left with you? A. Well, I am confident that I discussed them with Mr. Brown but I am not certain that Mr. Seagrave didn't see Mr. Brown before I did. In other words, at the time it was wired there making arrangements for Mr. Seagrave to meet Mr. Brown in Eureka, the one right below you there, sir, where there's various wires about making plane schedules and reservations and what not. Those were the wires that I was making to our Los Angeles office over our wire system and I just don't remember. I can't say completely, but I am certain I must have discussed it with him.

Q. At the time that you met with Mr. Seagrave and arranged for meetings between him and Mr. Brown, were you aware of the fact that Mr. Seagrave was representing the Cancer Institute, that it was a tax exempt organization? A. Absolutely; I certainly was.

Q. And you so conveyed that information to Mr. Brown? A. That's exactly right. The Cancer Institute

had a fine recommendation from my associates in Los Angeles—Beverly Hills, as being very outstanding people.

Mr. Resnick: I have no further questions of the witness at this time.

The Court: Do you have anything further, Mr. Kinsey?

Redirect Examination

By Mr. Kinsey:

128 Q. Mr. Boone, did you receive a fee for your participation? A. Yes, I did.

Q. What was the amount of your fee? A. One percent.

Q. And was there a written fee agreement? A. Yes.

* * * * * * * * * *

CLAY BROWN one of Petitioners herein, was called as a witness on his own behalf and, having first been duly sworn, testified as follows:

* * * * * * * * * *

129 Direct Examination

By Mr. Kinsey:

Q. Mr. Brown, you are a Petitioner in these proceedings, is that correct? A. I didn't hear you.

Q. You are a Petitioner in these proceedings? A. Right.

Q. And Clay Brown & Company was named after you or bears your name, is that correct? A. That is correct.

Q. It is stipulated that the corporation Clay Brown & Company was formed in 1946. Would you just tell the Court something about its operations leading up to your contact with Mr. Seagrave? A. Well, briefly, we built a sawmill in Fortuna, California—a Swedish gang mill. It was the first of its type in the State of California, used in production of fir logs into lumber. We commenced operation in 1950—January, or the first part of February, somewhere in that area, and then we added on to the operations as we went along. That was a thirty-six-inch Swedish gang mill and later we added a nine-foot band mill. As I stated, it was the first one in that portion of the country. We were received down there by the people very gratefully, particularly the ranchers. I had operated

130 in that Humboldt County, at which this mill was located with a plywood—fir plywood plant, the first

of its type in the State of California—integrated plant—became familiar with the timber in that area. I had been in the sawmill business practically all of my adult life and had conceived the idea that a gang mill would be ideal for that type of timber in that area. Shortly after we went into production with the gang mill and before the band mill was constructed and put into operation, the local citizenry down there gave a dinner party to the key men in our organization, and they were happy to see us come in—as I say, the ranchers were too, because there were a lot of bare spots in the timber areas down there that was ideal for ranching—cattle grazing—primarily cattle country. The timber was small, it lent itself to that type of an operation: The Chairman of the County Commission, a Mr. McLeod (phonetic), at that particular time, in a statement made before the group at this particular dinner—I think I said lunch a moment ago, but it was a dinner—stated that it would be a good thing for the County, because prior to that time, except in a few isolated locations, the small trees were ringed so they would die and they would go under the ground and they would be burned and the land would be thrown into grazing lands. By our coming in there, we were able to take that type of timber and convert it into merchantable lumber items, used
131 primarily in construction—boards and dimension as we use the term in our industry. Now, as we progressed—(interrupted)

Mr. Resnick: May I interrupt you for a moment? would you tell us what a gang mill is? A. Well, there are two types of gang mills, but this is what is known as a log gang mill. There is also a sash gang mill, but that's a different type. This is a Swedish gang mill—the name derives from Sweden, first built there and licensed to be made—to produce in this country.

Q. Maybe what counsel means, Mr. Brown, is the difference between a gang mill and a band saw mill. A. Well, a gang mill is a sash mill—a series of vertical knives and you pass the log through the knives, the sash moving up and down and the log in its entirety goes right through. From there, it goes in—from the process from behind the gang mill, the lumber is manufactured through the typical way through edgers and trimmers and planing mill and so

forth. The band mill is a single cut mill and the word band means that. The mill we had there was a nine-foot band mill.

Q. As I understand it, the gang mill was in operation around 1950, while the company was formed in 1946. What was the type of business during that—(interrupted) A. General wholesale lumber business.

Q. You heard Mr. Boone testify about his putting
132 you into contact with Mr. Seagrave. Would you start at that point and then recount what transpired thereafter? A. I first met Mr. Seagrave in Eureka, California, as Mr. Boone had stated. Mr. Boone had asked me at one time if we'd be willing to sell our operations. Our earnings were good. It was a family held organization. Over ninety percent of the stock of the corporation—one class of stock, was owned by myself and my family. I told him that if the price was right, I'd sell. We weren't looking for a sale or for a buyer and well, he said, "We may come up with something. We're in that business, securities business, trying to find the different operations or any sales that might be worthwhile to their clients." Well, that was the last I heard of it for some time. One day, I was in Fortuna where the mill is located—twenty miles south of Eureka on the California coast, and I had a call from Mr. Booth in my office, an associate of mine. He told me he had a gentleman in Portland; he'd talked with him, Mr. Seagrave in company with Mr. Boone and they were interested in the plant—at least taking a look at it. Subsequently, a meeting was arranged and I met Mr. Seagrave. He came to Eureka; I met him at the Eureka airport, took him out to the mill, took him over the area in general to see the type of timber that grew in that region. He was down there probably a day and a half or two days and then returned to Los Angeles. Following that,

I received—well, I think at that particular time
133 probably Mr. Seagrave outlined to me about how the Institute could operate and pay off on anything of this nature which they may acquire. I didn't give him an answer. I wanted to come back to Portland and talk to our directors and to our stockholders; first, to determine whether we wanted to sell, secondly, if we wanted to sell, what kind of a price we wanted for it. When we

finally made up our minds, if we could get a certain price, we would sell and I gave Mr. Boone the figures that we thought we should have, which was in the round figures of a hundred—a million five hundred thousand dollars, which included a note of a hundred and twenty-five thousand dollars payable to Mrs. Brown and myself in equal rights, which we had loaned to the Clay Brown Incorporation to build this mill plus a seventy-five thousand dollar loan from the RFC. From that point on, Mr. Seagrave came to Portland and we negotiated for several days and eventually we came up with a figure of a million three hundred thousand dollars, which included the note, which would bring the purchase price down to a million one seventy-five; but the note was an obligation. They were buying the capital stock of the corporation. Shortly thereafter, I guess it was the latter part of January, early February '53, the deal was consummated.

Q. What's your recollection as to how Fortuna Sawmills was selected or came into being? A. In the purchase
134 agreement, the Institute wanted someone to operate the plant. I think I first asked if they had know-how or if they knew of know-how and they told me no. They liked the organization we had and said they would like for the current operators to carry on the operation for an operating company if it could be formed. Well, I told them that I was just as interested as they were for the benefit of our stockholders, whether we operated it or not—that is, the old management. We were going to take a close look at who did because we wanted to make sure that our money—as sure as we could that our money would be paid in the sale. They couldn't come up with anyone—couldn't even suggest anyone and so in the presence of Mr. Souther, who had been my attorney on the Humboldt Plywood Plant in Humboldt County and who was familiar with that area in general, who represented me ever since our business—ever since I went into business for myself, which actually was in January—or July 1st, 1955, I said, "Would you be willing to form a company and I will operate the plant with the authority—with the permission from the Institute." The Institute was exploited and they insisted in the agreement that a management contract be drawn, which was a part of the instrument. That's how as I recall the Fortuna Sawmills came into the picture.

The Court: Excuse me, Mr. Brown. You said something about 1955?

A. 1945.

135 Q. At the time of the formation of Fortuna, were there discussions about whether you could or could not own a minority interest in Fortuna Sawmills?

Mr. Resnick: Discussions with whom?

Mr. Kinsey: Well, if you want to ask my next question for me, go ahead.

Q. With whom did you have any discussions and with whom did you have discussions as to whether you could or could not own a minority interest in Fortuna Sawmills? A. It was pointed out to me by Mr. Seagrave at one time that former stockholders of a corporation such as the Clay Brown & Company could own up to forty-nine percent of the operating company. And that came up in our negotations on the price. Well, I didn't look upon that with any favor at all, because number one, I do not care to invest money in an operation where I do not control it, but I did explore the possibility. I then went to my attorneys, Mr. Souther and yourself and showed them a letter of Mr. Seagrave, that outlined how this could be accomplished if we wanted to take advantage of it. They came back with the reply to me that they didn't altogether concur in that. Well, having a weak feeling toward having a minority interest anyway, it was dropped at that moment.

Q. Does Mr. Souther—did he or does he hold the Fortuna Plywood stock interest of his as nominee for you?

136 A. Yes.

Q. Is your nominee—by nominee, I mean, is he holding it for you? Do you have any interest in the Fortuna —(interrupted) A. Oh, no; no stock whatsoever.

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Q. Now, on the operations of Fortuna, what was your position with Fortuna Sawmills? A. I was engaged as General Manager.

Q. Would you then recount its operations during the ensuing years after February 4, 1953? A. You want

137 me to answer that in regard to the operation profitwise? If so, we have records here. I wouldn't attempt to relate them from memory.

Q. Well, you continued as general manager how long? A. I resigned as general manager in 1954 to take the presidency of M&M Woodworking Company of Portland.

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138 Q. After you went with M&M, who ran Fortuna operation-wise? A. Clarence Hill (phonetic) operated the sawmill; C. W. Booth more or less took over the general managership of it, who had headquarters here in our offices, which was the headquarters for Clay Brown & Company and was also the headquarters for Fortuna Sawmills.

139 Q. How long did the mills continue to operate? A. I recommended that that mill—the market went off rather sharply and substantial losses were being incurred, not only in the Fortuna Sawmills operation but other operations in similar position. If I remember rightly, I recommended in 1957, in a letter to Mr. Souther, President of Fortuna Sawmills that I thought the plant should be shut down after certain commitments—order files and so forth had been taken care of, and pointed out the reasons therefor and he agreed, and the plant was shut down. I can't give the exact month, I don't recall, but I am quite sure it was 1957.

Q. Did it resume operations again prior to the end of the five-year lease with the Institute? A. No.

Q. What happened around the expiration of the lease with the Institute? A. At the expiration of the five-year period?

Q. Yes. A. We felt, and when I say we, I am speaking for the former stockholders—that the Institute was in default of their contract, for lack of payment for the period within five years. I had a meeting in Los Angeles—or in Beverly Hills, with Mr. Castera, his legal representative, and Mr. Kinsey, yourself, and we found they were not in default. The time element had elapsed, yes, but there

140 was some ninety thousand dollars claimed by the Institute that was forgiven during a certain period of time—within a year's time, but not—that hadn't been paid. They took the stand—it was at my suggestion initially that we make these payments semi-annually to the Institute. The contract was written in that form but the plus or minus would be picked up after an audit. The

Institute took the position that if we had earnings in the first six months of the fiscal year, and which we did in this particular instanee, and losses in the last, and we paid the first six months on whatever the income was, that we could not apply it against the end of the fiscal year when the final audit was taken. That was their contention. That represented, as I recall, some ninety thousand dollars. So at that time, a supplemental agreement was drawn, which forgave Fortuna Sawmills the obligation of the ninety thousand dollars to the Institute; that the Institute through its efforts—best efforts, would attempt to sell the properties, or get someone else to operate the properties. And it went on for about a year; approximately a year. In the meantime, the Institute had been informed that the State Highway Commission was realigning a road, putting in a freeway and the freeway would go through the log pond, which was a seventeen-acre pond, the spur track would serve the mill and the planing mill—sawmills and the planing mill, would be deleted, and I—they talked to me about it, and I said, "It would be an island mill. We
141 don't want to have anything—I don't think you want to have anything like that on your hands." So from that point on, the Institute then began negotiations with the Institute—or the State Highway and the Institute, and I was kept informed, for the benefit of the former stockholders of Clay Brown & Company and they attempted, so I was told, to get about four hundred thousand dollars for the properties. They wanted to take just a portion of it, and I understood they was to sell—buy it all or none, as far as the Institute was concerned. So the final settlement was made and they bought all the properties.

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142 Cross Examination

By Mr. McNeil:

Q. Mr. Brown, was there any change in the management at the Fortuna location before and after the sale, or the transaction that we are discussing here? A. A change in the management?

Q. Was there any change in the management? Before and after the sale? A. No.

Were there any employees or excutives from the Institute—Cancer Institute—at the mill or employed at the mill? A. I'm sorry, I am a little hard of hearing. I can't hear you.

143 Q. Were there any employees or executives from the Institute—Cancer Institute—employed at the Fortuna location? A. No, not to my knowledge.

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144 Q. You have always maintained one office in this town, Mr. Brown? A. Since I have been in business for myself since 1945.

Q. This office is at 1111 U. S. National Bank Building?. A. Correct.

Q. The books and accounts of the present Clay Brown Company, Fortuna Sawmills operation, have always been maintained in Portland, in your offices, is that true? A. Clay Brown & Company's books are maintained in Portland and during the time of the operation of the Fortuna Sawmills, the records were kept in Portland.

Q. Now, do I understand, Mr. Brown, that the books and records of Fortuna Sawmills, Inc. were in your office here in Portland? A. That's correct.

145 Q. I believe you stated that after the mill became dormant or shut down, beginning some time in '57 or thereafter, that it was not thereafter leased to anybody —not operated? A. No, I didn't say that. I said that it was not operated again by Fortuna Sawmills.

Q. It was not operated again by Fortuna Sawmills. There was a lease in that period to another operator then? A. After the five-year period, there was a lease made between the Institute and an individual to operate the plant and operate it a few months with further losses and it was shut down. The lease was cancelled.

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146 Continued Cross Examination

Q. (By Mr. McNeil) Mr. Brown, who was the resident manager of Fortuna Sawmills? A. Clarence A. Hill.

Q. Now, he was resident manager before and after this transaction? A. Yes.

Q. After your resignation, did the personnel at Fortuna change? A. I didn't quite get that?

Q. After your resignation as manager, did the personnel otherwise change at Fortuna Sawmills? A. No.

147 Q. Did you visit the mill before the Institute deal was consummated? Did you go down there quite often? A. Oh, yes; I was down there quite frequently.

Q. Now—(interrupted) A. I happened to have properties down there in the same county.

Q. Did you continue these visits after the Institute transaction? A. You mean after the Institute had acquired the properties?

Q. Yes, did you look in at the mill whenever you were in Fortuna? A. Yes.

Q. And these would be frequent visits? A. Periodically.

Q. By periodically, once a month? A. Maybe once a month, maybe six weeks.

Q. Did any of your other companies sell Fortuna products? A. Yes, they did. The last year or so before we shut down, the Clay Brown & Company undertook the sale of the production. Up to that time, the sale had been handled by A. L. Hoover (phonetic) and Company in Los Angeles.

148 We were paying them three percent. Fortuna Sawmills was carrying the account. In the meantime, Mr. Hill had moved to southern California from the sawmill. My oldest son was at the sawmill, who has been identified in the business ever since he has been out of school.

Q. And what date is this? What date? A. This was prior to the shutdown, possibly a year before the shutdown of the plant.

Q. 1957? A. I think prior to that, yes.

Q. This would be generally 1957? A. So then, they suggested that to relieve the credit responsibility with the funds for part of the operating capital, that the Clay Brown should take it over on a three percent basis and assume all credit risks, which they did.

Q. Do I understand, Mr. Brown, that after your resignation as general manager of Fortuna Sawmills that you continued your periodic visits? A. That's right.

Q. Going back to the time of the transaction—this would be January or thereabouts 1953. Were you interested in

—personally interested in who purchased the stock in Fortuna Sawmills, Inc? Did you care who purchased the stock? A. The plant wasn't for sale. You are talking about the sawmill or are you talking about the operating company?

149 Q. I am talking about the creation of Fortuna Sawmills, Inc., and the capital stock of Fortuna (interrupted) A. Did I care who would purchase —(interrupted)

Q. Did you care who would—(interrupted) A. —who would be the operating company?

Q. Who owned the stock—did you care? A. Of the operating company?

Q. Yes. A. No, I didn't care, as long as I was satisfied that—representing the former stockholders, that adequate and proper management would be in there.

Q. In other words, you were interested in management and not ownership, necessarily? A. Had no ownership whatsoever.

Mr. McNeil: Thank you. No further questions, your Honor.

The Court: Anything further, Mr. Kinsey?

Mr. Moore: If the Court please, and it is agreeable with Respondent, I would like on recross to ask a couple of questions.

Mr. McNeil: Respondent has no objection, your Honor.

The Court: Mr. Moore, you may proceed.

Mr. Resnick: But the questions would be on redirect and not on recross.

Mr. Moore: Yes.

150 Redirect Examination

By Mr. Moore:

Q. Who did pay in the twenty-five thousand dollar capital that was mentioned, Mr. Brown? A. Mr. Souther and Mr. Kinsey.

Q. Who received the stock certificates for those—for this payment? A. I don't know how many stockholders they had, but I am certain that they received the stock themselves.

Q. Did you receive any stock? A. No stock.

Q. Did you pay in any capital? A. Did I pay in any capital? No.

Q. Did you loan any individuals any money to pay in any capital for Fortuna Sawmills? A. In the Fortuna Sawmills? No.

Q. Did you have any interest in the stock that was issued at all? A. None whatsoever.

Mr. Moore: If the Court please, at this time, there is one matter that we didn't bring out on direct examination that we would like to bring out at this time from Mr. Brown, and it would be considered that it would be direct examination and the gentlemen representing Respondent would have full opportunity to cross examine.

151 The Court: You may proceed.

Q. Mr. Brown, in the negotiations that have been testified to concerning the sale of the stock of Clay Brown & Company to the California Institute, I think you testified that you thought one million five hundred thousand dollars was a fair price and that this was negotiated with the result of one million three hundred thousand dollars, including these notes? A. That's right.

Q. Now, were there any supporting documents at all to justify this price? A. Well, after my first discussions with Mr. Seagrave, which were held in Eureka—we didn't discuss price—I wanted to go back to Portland and talk to the rest of the stockholders, and then with the assistance of my associate, Mr. Booth, we got out the appraisals, prepared by one of the—I am not sure, but I think the General Appraisal Company. Then we had the appraisal brought up to date. The apprasisal at that time was two or three years old, and there had been considerable improvements made. That, plus the earning statements gave us a feeling that the properties were worth—and timber acquisitions that we had—gave us—we felt it was worth a million five hundred thousand dollars, including the notes.

Q. I see. Do I understand then that you used
152 the appraisals which had been—an appraisal which had been previously made and that you had brought up to date and then also used the earning figures to justify your asking price? A. (Affirmative nod)

Q. Respondent and the Petitioners have stipulated that the sixteen pages of the 1951 appraisal from—made by the General Appraisal Company are exhibits and also a 1953 appraisal which brings the prior appraisal up to date have been stipulated to be entered as exhibits. Are these the appraisals that you are speaking of? A. Those are the ones I am referring to.

Q. You testified you received a note for one million three hundred thousand dollars, representing the purchase price, is that correct? From the Institute? The stockholders did? A. A note for that amount less the original down payment, as I recall.

Q. I see, but this—the note and the down payment represented the purchase price of the assets and the notes also? A. Correct.

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153 GEORGE CASTERA was called as a witness by and on behalf of Petitioners and, first having been duly sworn, testified as follows:

The Clerk: For the record, may we have your name and address?

The Witness: George Castera.

The Clerk: How do you spell your last name?

The Witness: C-a-s-t-e-r-a. 651 Siena Way—S-i-e-n-a, Los Angeles, California.

Direct Examination

By Mr. Kinsey:

Q. What is your occupation, Mr. Castera? A. I am President of the California Institute for Cancer Research, at UCLA in Los Angeles.

Q. How long have you been President? A. I have been president since 1952.

Q. And you are the Mr. Castera who signed the purchase agreement? A. I am.

Q. And some other related documents—(interrupted) A. I am.

Q. —on behalf of the California Institute? Would
154 you just explain generally the nature of the Institute's organization? A. Well, the California Institute of Cancer Research was set up by the University of California at Los Angeles Medical Center, as a non-

profit corporation, with the idea of stimulating public interest in the fight against cancer at the University. Dean Warren is medical director, formed the corporation and put on some of his doctors as members of the board, with the idea that little by little as time went on, why, they would be supplanted by laymen. The first president was a Doctor Freedgood (phonetic) and he was transferred to a medical school east and left a vacancy around 1952. Judge Stanley Barnes, who was then on the board of directors and Mr. Phillip Davis, an attorney, and at that time a State senator of California, asked me to have luncheon with them and knowing that I was particularly interested in cancer, having just lost my boy with cancer, they asked me to take on this presidency, to supersede Dr. Freedgood. Well, I wasn't particularly interested, with my other occupations and activities, I thought I was too busy, but my wife was Treasurer of the women's group and she persuaded me to take this presidency, which I did. Now, the Institute since has grown considerably. It has, in addition to its board of directors, all men, some twenty-two, consisting of General Omar Bradley as its chairmen and different business executives—Courtland Gross (phonetic), President of Lockheed, Judge Barnes and men like that, their interest being that they have lost people with cancer and want to do something about it. Now, in addition to that, we have three women's groups and they in turn have their own officers and they are located in southern California. Now, our main objective, of course, is to educate the public in the area that there is this dreadful disease and that they ought to do something about it. They help us in fund raising. The women give three or four functions a year. Each one, they stimulate people to mention us in their wills; money is given in lieu of flowers upon death. The Institute itself sends out numerous letters to the corporations in fund raising. We—with this background of our people, we are able to stimulate the National Cancer Institute and the agencies to put money in there. We have some very very important work going on that in my opinion is outstanding in the country. The medical center itself does more cancer work than all the other universities on the coast put together and a great deal of it is due to the insistence and

pushing and giving money to bring this work about. Mainly, that's our main job.

Q. How did the acquisition of the Brown stock and then its assets after liquidation fit into the scheme of things from the Institute viewpoint? A. Well, the deals
156 were brought to our attention. We looked at quite a number of them. I would say maybe two dozen of them, and we selected two, and our board and myself, or our idea being that eventually, if this ruling of the Congres of 1950 was workable, that we would—and we looked into it incidently in great detail, we would eventually end up with the properties and we could in turn sell them and use the money to fight cancer at UCLA, and that is why we took on this Clay Brown contract.

Q. How did the respective deals come to your attention? A. They were brought in by various brokers in Los Angeles —mostly brokers—stock brokers, people on Spring Street. The two we selected were both submitted by Mr. Seagrave, one of the leading brokers there and was interested in this type of work.

Q. Would you explain your knowledge of the negotiation of the Brown deal? A. Well, Mr. Seagrave originated it and asked me to meet with him at luncheon one day and he submitted the company as a prospect for our taking it on in a contract. We—in turn, I have on our board, an executive committee consisting of seven of the board members. Some of them—one is executive vice president of the bank and a couple of lawyers and one—the Regent at the University—and they told me to look further into it. We had the Vice President of the Security First National Bank at Los Angeles write up here to
157 check into the reliability of the management and we got a very glowing report as to their activities and what they had done in the past, so we told Mr. Seagrave that he could appear before our executive committee, which he did, and he submitted this company as a prospect for our purchase; and after due consideration on the possibilities—checking the local lumber markets and the earnings in the past, we thought that it would pay off in five years so we bought it.

Q. What was the main plum in the deal, so to speak, from the Institute viewpoint? A. Well, we were interested

in hoping that the property would pay off in the five-year time and then we would end up by owning it and in turn could sell it and use that capital for cancer research at UCLA.

Q. And also in the meantime, you got ten percent of—(interrupted) A. Yes, we got ten percent of the earnings during that period of five years. But our main—you asked the question of plum—I would say that we hoped to get the property whereby we could sell it and use that money for cancer research.

Q. Did the executive committee pass on the price? A. Yes, they did. They arrived at the price.

Q. To your recollection, what justified the price?

158 A. Well, those present on the executive committee—myself—oh, I had been a stock broker in business many many years, and I buy stocks and properties on earnings and we had checked the previous earnings and I felt that at the rate that they were earning, on five years, the price—in case they would miss a little bit—a little under a million and a half, which they wanted first, we came to the conclusion that they would make them a million three hundred, so we bought it at that price.

Q. Who—well, recount your recollection of the circumstances connected with the sale of the property to the California Highway Department? A. The five-year period had expired and the property should have reverted back to the owners and we renegotiated a contract with them that we would attempt to put future management in there to operate the property. And we weren't successful. We put one man in. I didn't know him, but he was supposed to be a lumber man that applied for the job and we made a deal with him, but it didn't last very long; so the State had wished to condemn part of the properties. I had never seen the properties, but I had seen photographs of it, and we had an outside counsellor—or I mean an investigator check the property on our behalf. We paid him a fee to tell us what he thought of its value and what could be done with it. He outlined the property in detail. There was

159 a large pond, some fifteen or sixteen acres under water that could be rented and that was exactly the location which the highway engineers had designated to put their new highway. Well, if we had done that, the

rest of the property would be—in our opinion would be not as valuable and we couldn't dispose of it without the pond. So the California engineers came to see me and I talked with them at length about it and insisted that if they wanted the property, they would have to take the whole thing. In turn of course, they could have condemned—by California law, they could have condemned that part alone—the mill pond, but it was very obvious to them after great discussion on it that they would have to move the—we showed them or I showed them that they would have to move the railroad track out of the way and that would have cost them more than buying the whole property, so they decided to buy the whole property. And we sold it to them.

Q. What was the Institute's attitudes or thoughts connected with management of the properties after you acquired them, upon the liquidation of Clay Brown & Company? A. Well, of course, my opinion and the opinion of the executive committee of our board, who were all businessmen, without management, you haven't got anything. We wouldn't be interested—I wouldn't personally be interested in buying a property that required management without having someone there that knew how to manage it. Now, I knew none of the people. I met Clay Brown maybe three years after we purchased the property. I never considered it my duties to interfere or even discuss anything with these companies. I looked upon the companies as an asset, several of which we have now—we get stocks, we get other properties—have had real estate and other things given to us, but I didn't discuss anything with the individuals, but we insisted that they have proper management and the stockholders of the managing company submitted some names and they said that they could run the mill at a profit so we approved of it. Made a deal with them.

Q. Did the Institute request Mr. Brown to continue the management? A. Not to my knowledge—no, I don't think so, but we insisted that we have proper management and that the people in the mill would stay—the operators of the mill, but I don't recall specifying any individual.

Q. Well, how was it that Mr. Brown was retained as manager? A. Evidently—I don't know. That was up to the stockholders of the operating company.

Q. To refresh your recollection on it, there is a provision in the lease between the Institute and Fortuna Sawmills that provides that the Institute can dictate who will be the manager. A. Yes, that's right; that's right. Well, we selected—we approved and we selected the group
161 that was in there to run it and they did very well.

Mr. Kinsey: That's all, your Honor.

The Court: You may cross examine.

Cross Examination

By Mr. Resnick:

Q. Now, Mr. Castera, at the time that you became president of the Institute, was it a tax exempt organization under the Federal Tax Laws? A. Yes, sir.

Q. And since that time, such exemption has been revoked? A. It was about 1957 when we heard of these—we had these two companies and we heard that there was a ruling called the Denver Ruling that—where the Internal Revenue frowned upon these lease arrangements. So we refrained from looking at any more of them but inasmuch as our main objective in this work is to lick cancer, we weren't particularly interested in anything about the finances or obtaining any more of these companies, so one of our directors, Judge Barnes was in Washington, and some of our directors back and forth there all the time, got in touch with him, and they went over to see the Secretary of Treasury, Mr. Humphreys and Mr. Humphreys brought in this senior counsel, Mr. Barnes, by name—I didn't know him either; but they arranged an agreement that rather than to liquidate all this excellent work that had been going on in
162 cancer—as I mentioned here—I will now, that it is the outstanding work in the country today—the research work itself, not our work; that they didn't want anything that would disturb it, so we were told—suggested that if we would set up a new corporation, they would give us an exemption, which we did, and we took all of the assets and all of the members and all the board and moved it into a new corporation and allowed the old corporation to stand as was, with the two lumber companies in them. Immediately after that, with the approval of the code group in Washington of the Internal Revenue, they took away

the exemption of the West Los Angeles Institute for Cancer Research. At the present time, it is a profit corporation.

Q. That is the old—(interrupted) A. That is the old corporation, yes. We renamed it West Los Angeles Institute for Cancer. It's a dormant corporation.

Q. Prior to the Clay Brown transaction, did you or any of your committee members see the mill at Fortuna? A. No, I never saw the mill—I am sure none of our other people had ever seen it.

Q. Did you ever see it after you acquired it? A. No, I was never at the property. I saw pictures of it during the one time there was a big—the Eel River went over and flooded it for about six feet and there was a great attempt to get that river straightened out and I asked General
163 Bradley when he was at his office in the Pentagon the next time he was east to do something about it and he did.

Q. Did you know who the stockholders were of the Fortuna Mills Company? A. No, sir.

Q. Did you have any personnel in the Institute, either on the board or otherwise, who were familiar with the operations or could operate the—(interrupted) A. Mr. Seagrave—Mr. Seagrave was a member of the board at that time and he—he saw the mill.

Q. But was he qualified to operate it? A. Oh, I wouldn't know.

Q. Did the Institute have any funds or resources available with which to purchase the Clay Brown stock for cash? A. If the board of directors so chose, they could have, yes.

Q. What were the financial resources of the Institute at that time? A. Oh, at that time, I don't recall exactly; but the Institute has, sometimes two or three hundred thousand dollars and then the University will do what they call, with grants of aid, will, through a chain of command at the University, ask for the money and it goes down to practically nothing and then it goes up and down,
164 back and forth, depending on how much money they want for research.

Q. Aren't your funds expended almost exclusively for cancer research itself? A. Yes.

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165 Q. At the time that negotiations were being undertaken in connection with the Clay Brown transaction, did Mr. Brown or any of his representatives seek from the Institute financial statements? A. No.

* * * * * * * * * * *

166 CHARLES WILLIAM BOOTH was called as a witness by and on behalf of Petitioners and, first having been duly sworn, testified as follows:

The Clerk: For the record, may we have your name and address?

The Witness: My name is Charles William Booth.

The Clerk: How do you spell your last name?

The Witness: B-double o-t-h. My address is 12912 S.E. Oatfield Road, Milwaukie, Oregon.

Direct Examination

By Mr. Kinsey:

Q. What is your occupation, Mr. Booth? A. I am the Secretary and Treasurer of Clay Brown & Company.

Q. And you are also one of the Petitioners in these proceedings? A. True.

Q. You have worked with me in preparation for some of the data for this case, is that correct? A. Yes, I have

167 Mr. Kinsey: I would like to have marked as Petitioner's Exhibit—whatever the next number is.

The Clerk: For identification, Petitioners' Exhibit 105.

(Whereupon, document referred to was marked for identification as Petitioners' Exhibit 105, Witness Booth.)

Q. I now hand this to you for your inspection. Did you prepare that exhibit? A. I did.

Q. What was the purpose of its preparation and what does it show? A. This is a chart showing the relationship between the net sales average and the direct costs per thousand board feet to manufacture lumber of the operation at Fortuna from the time it began operation until it closed down. This includes both the periods when Clay Brown & Company—the prior corporation, Clay Brown & Company operated it and during the period when it was operated by Fortuna Sawmills.

Q. And the lines going across are graph lines? A. That is correct.

Q. And it shows the continuity between Clay Brown & Company and Fortuna? A. Yes.

Q. And that is possible for this graph purpose, I
168 understand—why? A. The mill never ceased operations, when one took over from the other, so we were able to maintain statistics, if that is what you mean?

Q. No, I meant that in the case of Clay Brown & Company, they would have a depreciation deduction while Fortuna, it's a rental deduction, but these figures are before depreciation and before rental? A. That is correct. I took out the depreciation figures in computing this while it was being operated as Clay Brown & Company so it would be comparable to the figures after assumption by Fortuna.

Q. And the distance between the sales line—the sales realization line and the cost line would represent profit? A. Yes, sir.

Q. And then the figures down below are the actual profit figures—the gross profit and the net profit? A. That's correct.

Q. And these lines have varying degrees of proximity until they finally cross and they cross at what point? A. They cross in 1957 at just before the end of the six month's period that would end the fiscal—or half the fiscal year. It would end in October, 1957. It would be approximately August or September, 1957.

Q. Which is around the time the mill shut down? A. That is right.

169 Q. How do you account for the lines getting ever closer together and then finally crossing? A. There were several factors. One was that the market for lumber generally was dropping. The lumber market started to shade off in 1956, as shown by industry statistics and our figures were no different. Also we had, to some extent, lost a freight advantage, which the mill at Fortuna had previously had for shipments within the State of California. An ICC ruling had made lower rates out of Oregon. Previously, we had maintained a historic freight advantage. We then found that we had more competition from Oregon mills freight-wise. Also, during this period, costs were

rising and as a result, as shown here, these lines cross and we got to the point where the costs exceeded the sales average.

Q. But from 1950, when the mills started operation to early '53—in other words, the double line between '52 and '53 represents when Clay Brown was sold to the Institute, is that correct? A. True. That is right.

Q. Up to that time, the lines were pretty far apart, is that correct? A. Yes, and for part of the period after that, depending on market conditions and costs.

Mr. Kinsey: I would like to offer this as Petitioner's exhibit numbered as marked.

170 The Court: Any objection?

Mr. Resnick: I don't understand its relevance; I don't understand the assumptions made; I don't understand the sources of the data. Perhaps if I take the witness on voir dire, we may be able to obviate that.

Mr. Kinsey: He has all of the supporting information—the same information that was available when we showed it to you three days ago, and he will be able to give you anything you would like on that on cross examination.

The Court: I think he has the right to examine for the purpose of deciding whether or not to make an objection. You may examine for that purpose only now, Mr. Resnick.

Mr. Resnick: Would you like a copy of this, your Honor, while he is examining?

The Court: I have been furnished one, thank you.

Examination on Voir Dire

By Mr. Resnick:

Q. What elements have you incorporated in your direct costs? A. May I have a copy of the chart before I discuss this? (Document furnished)

Mr. Kinsey: If you desire your file at any time, request it and we will bring it up to you. A. Thank you. The net costs include all of the cost of manufacturing the

171 lumber with the exception of depreciation through shipping, but excludes administrative costs. It includes the cost of the logs and all the manufacturing costs.

Q. Is freight included in your direct costs? A. No, sir, because we—freight is not—normally, we refer to our sales average as the average sales price at the mill.

Q. Was any part of the overhead burden incorporated into the graph? A. No, it was not.

Q. I notice you have a legend at the right side of the graph, at the bottom, where you say that you have included the cost of logs less depreciation and rent? A. Yes.

Q. Do you mean that—the depreciation is not that depreciation that relates soley to logs? A. No, sir.

Q. What was the source of the information? A. I took this information from the working papers of Fortuna Sawmills. I was the controller of Fortuna Sawmills and in that capacity, was in charge of the monthly records which we prepared and worked with the auditors at the time of the annual audit.

Q. Were you also the controller of Clay Brown & Company prior to the February 1953 transaction? A. I was the Secretary and Treasurer of Clay Brown & Com-
172 pany and acted in the same capacity.

Q. Were the figures that you seek to chart out on Exhibit 105 for identification the figures that were used in determining the payout to the Institute for its rent? A. Except for the fact that in determining the Institute's —the rent for the Institute, we included administrative and sales costs, which were not included in this chart.

Q. What were the administrative costs that were excluded? A. Office help in the sales office; commissions payable to the sales personnel in our sales offices; and the general office overhead, except for at the mill office. The mill office costs were included.

Q. What about the sales expense in the Clay Brown Company portion of the graph, on 105 for identification? Have they likewise been excluded? A. They have, yes. These were prepared on the same basis.

Mr. Resnick: I have no objection to the receipt of the exhibit.

The Court: The exhibit will be received.

The Clerk: Exhibit 105.

(Thereupon, Petitioners' Exhibit No. 105, Witness Booth, received in evidence.)

The Court: May I just ask a question? When you
173 were referring to the sales, you said they were sales at the mill, did I understand you correctly?

The Witness: Yes. What I meant was, the sales realization at the mill. Actually, there was freight involved. The lumber went elsewhere for disposition, but we figured the net return at the mill before the freight is involved in shipping it out.

The Court: In other words, you took what was paid to you for it and subtracted the freight from that?

The Witness: That's quite true, and quite often, the sales were made at the mill level. The customer might send his truck to the mill and pick it up there, so that freight was not always involved. In order to get a comparison and a steady average, we excluded freight from everything. But if it was sold on a delivered basis, for example, f.o.b. at Los Angeles, California, then we deducted out the freight cost to come back to the mill—realization at the mill.

The Court: Thank you.

Continued Direct Examination

Q. (By Mr. Kinsey) Mr. Booth, you stated that overhead is not shown on the graph? A. That's right.

Q. By that, you mean on either of the two lines? A. That is right.

Q. But in the figures down at the bottom, there
174 is gross profit and net profit; and the net profit—the difference between gross profit and net profit is that overhead is deducted off the gross profit to arrive at net profit? A. That's right, yes.

Q. So on the paper as a whole, it does show net profit after overhead, but it is just the lined graph does not? A. That is true. The figures at the bottom show that. The line graph does not.

Mr. Kinsey: In view of that, would you have any other questions you would want to ask, Mr. Resnick?

Mr. Resnick: Not on the exhibit. I have no objection to its receipt.

Q. Another question in relation to this—to your knowledge, when Clay Brown & Company was sold to the California Institute, could the trend of these lines have been anticipated at that time?

Mr. Resnick: I'm sorry, I didn't hear the question.

Q. Could the trend of these lines have been anticipated on February [redacted], 1953, at the time Clay Brown & Company was sold to—(interrupted)

Mr. Resnick: I object, your Honor. The witness hasn't been qualified as one who can give an opinion as to economic trends in the lumber market. In the absence of such qualification, I don't believe that an opinion can be given by him.

175 Mr. Kinsey: We may recall Mr. Clay Brown for that, but maybe as a second class expert he can answer.

(Laughter)

The Court: Well, it will be received—the witness' opinion. He apparently has been in the lumber business for some time and you may cross examine him as to his qualifications as well as otherwise. A. My opinion is that the trend of these lines could not have been shown, nor could anyone even today project for five years what the lumber market or costs of manufacturing lumber are going to be with any degree of accuracy.

Q. Now, at the time the sale was negotiated, Mr. Brown testified, I believe, that you participated in the generation of the figures or data that justified the price you were asking? A. That's right.

Q. Would you explain what you did in that connection and the negotiations relating thereto? I think you are aware of the letters that you have written and received in that connection, which are in the stipulation. A. Yes, I was asked to prepare several schedules on several occasions, showing the assets as they were and as—relating to the—initially relating to the appraisal we had taken in 1951 and to look over other assets that may not have been included in the appraisal and there were some, such
176 as land, for example, and timber was not included in the apprasial; and to make up schedules showing a more realistic approach to the actual values of these assets, and then, after it was decided that a revision should be made of the appraisal, to bring it up to date, I was again asked to go over those figures and to analyze them and to present them in a pro forma balance sheet to show what might well be termed actual values of the assets of the corporation.

Q. Now, what's the difference between the pro forma balance sheet you talked about and the actual balance sheet? A. The actual balance sheet, of course, would have been the Clay Brown—(interrupted)

Mr. Resnick: If your Honor please, unless we have the balance sheets in front of us and are somewhat identified I think the question is completely meaningless.

Mr. Moore: I think they are in the stipulation.

Mr. Resnick: Then they should be identified if they are in the stipulation and they should speak for themselves.

Mr. Kinsey: I think that is a good point. I will identify them. If the Court will pardon us for—(interrupted)

Mr. Resnick: If Mr. Kinsey will tell us what he hopes to establish by this witness that hasn't already been established in the one hundred and five exhibits, perhaps
177 we can agree with him.

Mr. Kinsey: Oh, fine. What I was going to establish was that he took the actual balance sheet of Clay Brown & Company of recent date—that is, recent date to February 4, 1953, which showed book values; then in place of the book values, he substitute actual values and then I was going to question him as to his source of the actual values and then I was going to ask him how close the total came to a million three and that was the line of questioning.

Mr. Resnick: Everything you say is fine, except I don't understand what you mean by actual. If you meant by that, the values per the appraisal, then, of course, those figures are already in the record too.

Mr. Kinsey: I think they would be a very strong indication of actual value, but I wasn't necessarily—(interrupted)

Mr. Resnick: Well, I don't know. They would be the values that appear in the appraisal. Your definition of actual and mine might be different.

Mr. Kinsey: Well, if you are telling me what his answer as to actual value would be, that may well be, but perhaps the witness can answer just as well.

The Court: You may proceed, Mr. Kinsey.

Q. I hand to you Exhibit 28-BB, 27-AA—I believe those are the two letters written by you. Now, in those let-
178 ters—I am talking about two exhibits, and maybe you can identify which of the two this statement would

apply to—you show where in—I use the term actual values, you can use whatever term you choose—should be substituted for the book values as taken off the financial statement, is that correct? A. Yes.

Q. What term would you choose—did you use in those letters? Should we use—rather than actual value—(interrupted) A. Reconstructed valu .

Q. Reconstructed value?

Mr. Resnick: What value d you use in the letter, sir? A. The schedule attached to Exhibit 28-BB, shows a value of one million five thousand sixty dollars.

Q. Now, how did you arrive at that figure? Maybe if you would just explain how you generated that figure, you will answer all the questions I want to ask? A. I might explain that this was prepared prior to having the new appraisal—before the appraisal had been brought up to date. I took the assets as shown on the books of Clay Brown & Company; then I added several assets which had been added or improvements which had been made of a capital nature, since the appraisal.

179 Q. Did you use book values on the additions? A. Yes. For the most part. In some instances, I didn't. For example, I showed four automobiles, present value, ten thousand dollars, that was an estimate. And I showed timber. That was an estimated value, but in the other instances of actual—where we actually purchased assets for installation at the mill, I used actual values. Where I had the actual figures, I used them. And then I have a column in this exhibit, as you will note, that says "plus items expensed". Sometimes it was difficult if not impossible to keep the crew who were building at the same time were making lumber, separated and it was felt that a good deal of the construction and the addition to the capital values of the mill did not reflect in the figures. It might have ended up as cost of operation, so those were added, and in that manner, I came to a million five thousand dollar figure.

Q. To what extent in that did you use the appraisal, which as you explained was the appraisal before the updating one? A. I used it as a basis for almost the entire list—the appraisal I have listed as in the first column here, coming down to the total as shown on the appraisal.

Q. Then what were the circumstances about the subsequent appraisal? Why was that gotten and so forth? A.
180 Because of the fact that we had added quite a number of assets and because of increased costs of replacement, there was inflation at the time, and it was indicated that the cost of these items would be increased to get actual value at January 1953, so for those two reasons, it was decided to be more accurate and better documentation if the appraisal were brought up to date.

Q. And it was brought up to date? A. Yes, it was.

Q. Are you the one who contacted the appraisal company to have it brought up to date? A. I don't recall where I made the first contact. I do recall that I talked to Mr. Dean of the General Appraisal Company about the situation and asked him to do it.

Q. Did he know the purpose of the appraisal? A. I presume he did.

Mr. Resnick: I move that that be stricken. The answer is obviously hearsay.

A. I am not sure.

The Court: Well, he says he is not sure, Mr. Resnick, so I don't see much point in striking it.

Q. Anyhow, the purpose of the appraisal was to arrive at what? A. To arrive at values of the equipment for replacement purposes and depreciated values and I presume—I won't say I presume—and for insurance
181 purposes, which is always done in appraisals of plants. They give you three schedules of values.

Q. Three schedules? Maybe we should have that appraisal. I will hand you Exhibit 31-EE—and that is the subsequent appraisal? A. That is right.

Q. What impact then did that have upon that reconstructed value you said you used without benefit of the updating appraisal? A. This indicated the plant was more valuable than we had anticipated. We found additional values by having the appraisal made—or the appraisal brought up to date.

Q. It more than substantiated then the figures that you have in your reconstructed value? A. Yes.

Q. By reconstructed value, I mean in your letter under your label reconstructed value? A. That is right.

Q. Under what heading were the figures—what is the heading on the column of figures in the appraisal that you took off for your reconstructed value? A. The heading is "new replacement value".

Q. New replacement value? A. Yes.

Q. And that figure has a depreciation factor in
182 it. What would—is that right? A. Yes, that's right.

Q. In other words, if it's two years old, they don't give you the cost of a brand new one, but they give you the cost of what a—(interrupted)

Mr. Resnick: If you are going to testify, Mr. Kinsey, you ought to be sworn.

Q. You explain. You can explain it better than I can. A. I will explain it to the best of my ability. The new replacement value is the estimate of the appraisal company as to what it would cost today to put similar equipment in place at that time.

Q. Of the same aged equipment? A. Yes.

Q. Not new equipment, but the same aged equipment? A. That is right, and Mr. Dean told me at that time that the appreciation—in other words, inflation—the cost of replacing this type of machinery was such that he felt that depreciation offset—was offset by increased construction costs for replacement purposes.

Mr. Resnick: I move that that part of the answer which begins "Mr. Deal told me" be stricken as hearsay and not binding on the Respondent.

Mr. Kinsey: I would say in opposition to the motion that he is explaining the background for some figures
183 he has used that are a stipulated exhibit.

Mr. Resnick: The exhibit may be stipulated, but we didn't stipulate to what Mr. Dean told him. If you want Mr. Dean to tell us something, Mr. Dean should be here.

The Court: The motion is overruled.

Q. Now, in your reconstructed value—I guess you can put that one exhibit down, if you want. In the reconstructed value, what did you have the timber in at? A. Mr. Kinsey, we made two or three different projections here, as we were going along, and I want to be sure that I understand what reconstructed value we are talking about. Are we talking about the one before the new appraisal? Or after the new appraisal—after the appraisal was brought up to date?

Q. Well, you come up to a figure of a million something, don't you? A. In both cases.

Q. What is it in one case—what is it before the new appraisal? A. One million five thousand sixty-eight dollars.

Q. What is it after the new appraisal? A. I don't have those figures in front of me. I have them, however, back there. In my other records.

184 Q. Subject to your verification, was there much of a variation? A. Not a great deal. I believe it was about a million fifty thousand.

Q. Well, in the one that you have there, what value is the timber at? A. One hundred and twenty-three thousand dollars.

Q. And that was how much per thousand? A. Eight dollars and twenty cents based on fifteen million feet.

Q. Now, how did that prove out, using—substituting hind sight now for the knowledge you had then? A. Actually, out of the timber, there was more than twenty million feet harvested.

Q. And what was the—do you have any reason to substitute or use a different value than the—(interrupted) A. Yes, we had an appraisal made by a timber—Mr. Reardon (phonetic), a timber salesman and timber broker in Eureka. He figured that nine—he gave us a letter, nine dollars per thousand feet was at that time about the value of the timber.

Q. That letter is in as an exhibit. We will identify the number—but you are acquainted with that letter? A. I am.

Q. We will give you the date on it, but it was prior to December—it was prior to February 4, 1953, it was some time in 1952? A. I think it was.

185 Q. But rather than using the nine dollar figure, you used—(interrupted) A. Eight dollars and twenty cents.

Q. So if you used actual values—I mean actual quantities as proved out by subsequent operations, and the nine dollar figure, what would you get? A. We would have increased this fifty-seven thousand dollars.

Q. But even without the increase of the fifty-seven thousand, your total was one million what again? A. One million five thousand sixty-eight dollars.

Q. And then how did you justify the difference between that and a million three? A. Partially on earnings record; partially on the fact that it was a going corporation and it was difficult to buy machinery in those days and to get quick delivery, and we had a mill. We had it in operation and it was showing profits and these were some of the factors that were considered. We had a sales organization. It was doing a good job for us. All of these were tangible to us and was a factor that we felt justified a purchase price in excess of these reconstructed values.

Mr. Kinsey: For purposes of the record, that Reardon letter is dated May 1, 1952, and it is Exhibit 81 quadruple C.

186 Q. Did Mr. Seagrave question your values? A. Yes.

Q. Did you convince him? A. Yes, we did. I think we did. We seem to have.

Q. But anyhow, the price evolved at a million three? A. Yes.

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187 BEFORE THE TAX COURT OF THE UNITED STATES

Transcript of Hearing—January 28, 1961

U. S. Court of Appeals
U. S. Courthouse (New)
Portland, Oregon
Thursday,

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188 CHARLES WILLIAM BOOTH resumed the stand and testified further as follows:

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Continued Direct Examination

By Mr. Kinsey:

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189 A. At this stage of the negotiations, we were asking a million three hundred thousand dollars for the stockholders.

Q. For the stock alone? A. For the stock alone.

Mr. Kinsey: That's all on this exhibit.

Q. Now, the spread between your reconstructed asset value and your asking price, you supported how? A. By the fact that good earnings were behind the corporation and that it was a going concern and that it would take time to build another similar facility as well as difficulty in getting machinery and so on. Primarily because of the good earning record.

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Q. Now, getting to Fortuna and its organization, did you attend the conference at which you might say its birth was decided upon? A. Yes, I did.

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Q. Would you recount your understanding of that birth?

Mr. Resnick: Object, your Honor. I think we should have a foundation laid—time, place, persons present if the witness wants to recount what was said there. That might be unobjectionable, but his impressions of a conference the date of which and the place of which—(interrupted)

192

Mr. Moore: We will ask the proper questions.

Mr. Resnick: We suggested that a long time ago.

Mr. Kinsey: Well, then I thought it might be leading. If we might suggest to him that there was such a conference.

The Court: In light of the objection, would you be willing to lay a foundation? Then I won't rule on the objection.

Q. Yes. What was the approximate time of the conference? A. Late in 1952—probably in Decemebr, 1952.

Q. Where was it? A. It was in the offices of the U. S. National Bank Building.

Q. Who was present? A. Mr. Seagrave, Mr. Souther, Mr. Brown and myself. Are the ones I recall. There may have been someone else.

Q. And then—you can go on with your recounting of the birth of Fortuna? A. As I recall, there had been, on our part, an assumption that—it was known that an operating company was to be formed. We had not up to that point discussed to any great extent who would supply the operating company, and when we reached this point in the negotiations, it became necessary to establish such a company or to have one established or set up or arranged for; and as I recall, Mr. Seagrave was asked if the Institute wanted to provide an operating company or any suggestions in that respect; and there was no

193

suggestion there and Mr. Brown was asked if he had someone in mind and he turned to Cal Souther, who was there, and said, "Why don't you serve the company, Cal?" And I don't recall that Souther accepted right then, but I do recall that that was the time at which this subject was broached to him.

• • • • • • • • • • •

194 CHARLES WILLIAM BOOTH resumed the stand and testified further as follows:

Cross Examination

By Mr. Resnick:

• • • • • • • • • • •

195 Q. On how many occasions did you meet with Mr. Seagrave? A. I don't know. I would—do you want an assumption?

Q. Your best recollection? A. Probably three or four prior to the end of—during the negotiations.

Q. When did your first meeting take place to the best of your recollection? A. First meeting took place in the offices of Mr. Boone, of Dean Witter & Company.

Q. Who was—who were present at that meeting other than you and Mr. Seagrave? A. Mr. Boone.

Q. Was Mr. Brown there? A. No, he was out of town.

Q. Did all your meetings take place here in Portland? A. Yes.

Q. You didn't meet with Mr. Seagrave in Los Angeles? A. No.

Q. Do you know whether Mr. Brown met with Mr. Seagrave at times when you weren't present? A. Yes, he did.

Q. Some of those meetings were held outside of Portland?

A. Yes, I know of at least one in California—in

196 Fortuna.

• • • • • • • • • • •

197 A. Oh, yes.

Where was that office? A. In the United States National Bank Building in Portland.

Q. That was the office that was also occupied by Mr. Clay Brown? A. Oh, yes. No reason to change.

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198 LOUIS H. SEAGRAVE was called as a witness by and on behalf of Petitioners and, first having been duly sworn, testified as follows:

199 Cross Examination

By Mr. Resnick:

. . . . . .

200 Q. Were you and your partner Mr. Rea—R-e-a—at one time authorized by the Institute to seek out businesses that the Institute might acquire? A. Yes, that is correct.

Mr. Resnick: We have no further questions of the witness at this time.

The Court: Is there anything further, Mr. Kinsey?

Mr. Kinsey: I just have one question which may actually be resumption of direct, if I may.

Redirect Examination

By Mr. Kinsey:

Q. I refer to Exhibit 55 triple C, which are the minutes of a special meeting of the board of directors of the California Institute for Cancer Research. They disclose that you were chairman of that meeting and I am reading from the second page of the minutes. It says: (Reading) "Mr. Seagrave then received—or reviewed, rather the proposed purchase of Clay Brown & Company of Portland and Eureka and submitted various papers which are attached to the minutes of this meeting. He disclosed that his interest was a two percent commission to be paid by the sellers when and if payments on the purchase price are made." Did you receive a commission pursuant to that? A. The commission was established and some payments were

201 made; however, the amount of payments made did not anywhere near cover the expenditures I had made. There was no profit in it.

Q. And Mr. Boone testified that he got one percent. So does your recollection—(interrupted) A. His company got one percent.

Q. There was a three percent commission? A. That's right.

Q. Two percent to you; one percent to Mr. Boone? Or to Dean Witter? A. That's right.

Q. Further on in the minutes, there is a resoultion that says that a legal committee is hereby appointed to consist of Mr. Phillip Davis, Judge Stanely M. Barnes, Judge Frederick F. Houser, to go over the agreements and make any revisions they felt to be in the best interest of the Institute and to pass and approve other documents in connection with the proposed purchase. This is talking about the Clay Brown purchase. I, together with counsel for Respondent, have reviewed the minute books of the Institute and we don't find any minutes specifically showing that the legal committee did approve those documents. Did that legal committee approve the agreements? A. Yes, and I can tell you the circumstances, if that would help to make you understand.

202 Q. Yes, fine. A. I believe that I had indicated that I would like to have them okay them by noon of a certain day, because I was scheduled to go up to Portland for the closing. They had had these documents and they hadn't quite completed them. They got together—at least two of them—the two judges. They completed their examination and the approval was conveyed to me. I promptly went to—up here and we concluded the arrangement. It was oral, but I talked to each one of them over the telephone. Probably the only reason for it not being covered was that they had been appointed, everyone knew they had acted, and I was away for quite a little while and perhaps neglected to note the minutes.

. . . . . .

CLAY BROWN was recalled by and on behalf of Petitioners and testified further as follows:

Direct Examination

203 By Mr. Kinsey:

Q. I refer to Exhibit 105—that is Petitioners' Exhibit 105—this is a chart that Mr. Booth prepared which I think you have previously inspected. I believe it is disclosed in that chart and in other testimony, things did not go exactly as anticipated, but going back and looking at it as of the time of negotiations, February 4, 1953, and a little prior thereto, during the period of negotiation, what were your prospects for the business—your reasonable prospects?

Mr. Resnick: As of what date?

Q. As of for the future.

Mr. Resnick: As of what date are you—(interrupted)

Q. As of January or February, 1953? A. We looked upon the market as very favorable. We saw no reason why it shouldn't carry on at that particular time for more or less of an indefinite period; and looking at this chart, it shows that sales carried on in pretty good fashion with a margin of profit and to about the third or fourth quarter of 1957. We had every reason to believe and our calculations were based upon that, that our earnings would be maintained to a reasonable sum or amount and I think this chart pretty clearly indicates that. Now, the change in the market conditions was certainly beyond the control of our company or any other company, identified in the same industry.

204 We had a recession there; housing starts dropped off; money got a little tight at that time; costs were increasing, but we couldn't forsee all of that. Possibly some of it—we couldn't forsee a sharp break which occurred here in the drop in sales in the third and fourth quarter of 1957.

Q. Well, then, as of that period we talked, you had, in accordance with your best business judgment, no idication that any bloom was off the rose, so to speak? A. None, other than the fact that historically, we have had our ups and downs in the lumber business, but the line has been in this direction and certainly, we would be in a recession for a short period of time and then it recovers. But in this particluar instance, it hasn't, and as of this date, there hasn't been any material increase. As a matter of fact, it is even worse today, market-wise and costs are still higher. Manufacturing costs.

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CLAY BROWN & COMPANY
Portland, Oregon

STATEMENT OF GROUNDS FOR APPLICATION OF BENEFITS OF SECTION 443

Fiscal year ended April 30, 1950

The company has applied, in accordance with Section 447(c) of the Excess Profits Tax Act of 1950, for permission to compute its excess profits credit under the provisions of Section 443 of the Act, and in support of such application, the following statement of the grounds upon which the taxpayer relies was submitted.

The company, an acquiring corporation, was incorporated on September 28, 1946 and began business on October 1, 1946, succeeding a partnership formed on July 1, 1943 which carried on business under the name of Brown-Ross Company, until March 1, 1946 and under the name of Clay Brown & Company until acquired by the company under Section 112(b)(5).

The company qualifies as an acquiring corporation as defined in Section 461(a)(1)(D) of the Act and is thus deemed to have commenced business on or before the first day of its base period (Section 461(d) of the Act), thereby meeting the requirement of Section 443(a).

The excess profits net income for the base period has been computed in accordance with Section 462 of the Act in a schedule attached to Schedule EP-2 (Form 1120) in order to determine the monthly average for the period as required in Section 443(a)(3).

Prior to the taxable year beginning October 1, 1949 and ending April 30, 1950, which year has been designated in Schedule EP-5(C)—line (C) as that in which a substantial change in products or services furnished by the taxpayer first occurred, the company operated as a broker engaged in the sale of lumber products on a strictly commission basis without handling the products sold. Unable to operate profitably due principally to insufficient volume, the company decided to become a lumber manufacturer and sell its own products. It secured a guaranteed log supply in the Humboldt (California) area, purchased a farm in Fortuna, California, and tore down the farm buildings and

[illegible] began building a sawmill and log pond in August, 19[illegible] which was completed in December, 19[illegible]. The first log[illegible] were delivered only in December, 19[illegible], and the first log[illegible] were sawn the [illegible] later, in the same month, and the company had lumber available for sale to customers prior to December 31, 19[illegible].

SCHEDULE EP-2 COMPUTATION OF EXCESS PROFITS NET INCOME—BASE PERIOD

Fiscal year ended April 30, 1952

	Predecessor Rivers Bros. Company 7/1/45-3/29/46	Predecessor Clay Bros. & Company 4/1/45-9/29/46	Fiscal year ended 9/30/47	Fiscal year ended 9/30/48	Fiscal year ended 4/30/49	Short year 10/1/49-4/30/50	Total Schedule EP-5(c), Line 2
1. Normal tax net income	$ (1,729.59)	21,754.00	62,613.59	100,894.54	(6,179.96)	5,729.53	
2.							
3.							
4.							
5.							
6.							
7.							
8. Dividends received credit				222.75			
9.							
10.							
11.							
12.							
13.							
14., 15., 16.							
17. Total of lines 1 to 16, inclusive	(1,729.59)	21,754.00	62,613.59	100,669.29	(6,179.96)	5,729.53	
18. Dividends received		220.53		275.00			
19. Capital gains							
20.							
21., 22., 23., 24.							
25. Total of lines 18 to 24, inclusive		220.53		275.00			
26. Excess profits net income (line 17 minus line 25)	(1,729.59)	21,533.26	62,613.59	100,621.29	(6,179.96)	5,729.53	
27.							
28. Excess profits net income for base period months years prior to year in which entitlement change occurred	—	21,533.26	62,613.59	100,621.29	—	—	185,769.74
Number of months	3	7	12	13	12		45

CLAY BROWN & COMPANY

DEPRECIATION SCHEDULE

Year ended April 30, 1952

	Age when acquired	Assets				Allowance for Depreciation			
		Balance 4/30/51	Additions	Sales and Retirements	Balance 4/30/52	Balance 4/30/51	Current year's provision	Sales and Retirements	Balance 4/30/52
Buildings	Various	$126,698.49	6,851.96	—	173,550.45	3,995.33	3,373.96	—	17,442.29
Equipment and facilities	New	370,798.30	21,098.13	—	427,283.43	30,880.04	34,256.62	—	30,935.66
Automotive equipment	New	19,807.69	21,191.89	6,595.35	34,404.23	4,690.73	8,687.27	1,680.83	11,697.17
Furniture and fixtures	New	13,243.37	1,453.80	100.80	15,227.37	2,457.36	1,233.14	56.13	3,634.39
		$577,113.35	30,593.14	6,794.95	650,971.84	35,673.50	48,732.99	1,907.61	83,699.48

Life used in accumulating depreciation

Buildings	30 years
Equipment and facilities	5-15 years
Automotive equipment	4 years
Furniture and fixtures	15 years

210 **Exhibit 23-W**

DEAN WITTER & CO.
Portland 4, Oregon

November 28, 1952

Mr. Lewis H. Seagrave
395 Patrician Way
Pasadena 2, California

Dear Mr. Seagrave:

Subsequent to your call to our office in Portland, I have contacted Mr. Clay Brown of Clay Brown & Co., Inc., and he has indicated an interest to proceed with the possible sale of his company to the California Institute for Cancer Research.

Enclosed you will find statements for additional years together with the statement for August 31st, 1952. The current 6-months statements Mr. Brown has with him and they are substantially better than those for 1951.

Also enclosed is a photograph of Clay Brown & Co., Inc., which, even though it is considerably out of date, will give you the general idea as to the scope of this operation.

Mr. Guy Witter attempted to contact you for the purpose of arranging an interview between you and Mr. Brown today, November 28th, but I understand that he was unable to do so. However, Mr. Brown will be spending the week of December 1st to 6th at his plant in Fortuna, California, and would be very pleased to have you come up and see for yourself, should the enclosed facts and figures appear attractive for your consideration.

Should such a visit be possible, I would appreciate your contacting Mr. Guy Witter in our Los Angeles office so that he can inform me in order that I may be able to schedule a mutually agreeable time for you and Mr. Brown to meet.

211 In proceeding, I believe that this company qualifies along the schedule you left with me. Mr. Brown's offer is the 32,000 shares at $40.00 per share or 1,280,000 dollars with a cash down payment. It appears to me because of the current ratio of the company that it is not likely that such a down payment could be made so his other offer is $45.00 per share for the 32,000 shares with no down

payment. Mr. Brown has agreed to pay Dean Witter & Co. a 2% commission for negotiating this transaction.

I enjoyed very much meeting you and hope that some mutual agreement can be worked out.

Yours very truly,

DEAN WITTER & Co.
William B. Boone

WBB/pf
enclosures

212 **Exhibit 24-X**

PROCEDURE IN INSTALLMENT SALE OF ALL STOCK OF A CORPORATION TO THE INSTITUTE, A TAX-FREE CORPORATION

1. To qualify, the corporation must be closely held, have a good and relatively steady record of earnings, have a strong and liquid net current position, own valuable fixed assets, and show the effects of good management. Fixed assets should include 50% land and buildings.

2. All of the stock of the corporation is sold by the owners to the Institute for an agreed price. The Institute gives its note for the purchase price.

3. The Institute dissolves the corporation, becomes possessed of the corporation's assets. It may pay the sellers as a down payment, an agreed amount of cash from the corporation's assets.

4. A real estate trust deed, and a blanket chattel mortgage covering the fixed assets of the dissolved corporation, are deposited with the sellers as security for the unpaid Institute note.

5. Under some circumstances a loan may be negotiated on the fixed assets in order to provide funds with which to increase the down payment.

6. A new operating corporation is formed with *nominal* capital, and this new corporation enters into a five year lease agreement with the Institute covering all the fixed assets received in the corporation's dissolution and agrees

to pay an annual rental therefore of an amount equal to *80% of the new company's net earnings before taxes.*

7. The new company also buys the net current assets, taking over the current assets and assuming the current liabilities. The new company gives its note, payable over a period of years, for the amount of the net current assets. This note is deposited as additional security for the Institute's note to the seller.

8. The Institute will subordinate its note from the lessee company to reasonable bank loans of the new lessee company, thereby making bank loans possible, and improving its credit position.

9. No fixed assets may be sold by the Institute without the approval of the seller, and the entire proceeds of any such sales are applied immediately on the Institute's purchase note held by the seller, without any deductions.

10. The Institute also pays on its note held by the sellers, annual amounts equal to 90% of all rentals received on its lease to the new operating company.

11. When the Institute's note has been paid, the rental on the lease to the new operating company is ordinarily reduced to 60% of net income before taxes.

213 12. The seller or sellers, as a group, may own a minority interest, usually 40% to 45% of the new company's stock, but none of the sellers may be directors or corporate officers of the new company. However, the principal seller, or president of the present corporation or his nominee, is usually employed at a salary comparable to his former salary as general manager of the new company with full powers to operate the new company. Other key personnel may be employed as assistants to the general manager.

13. The new operating company may be owned by the sellers (up to 45%), key employees, bankers arranging the transaction, friends, lawyers, accountants, or others in whom confidence is reposed.

14. Due to provision of the 1950 Federal Income Tax Law, a lease arrangement with a lessee corporation may

not be for more than five years. However, a new lease may be entered into with another corporation, with other owners, officers and directors, in which the present sellers can likewise own such a minority interest.

15. The sale by the seller to the Institute, and the agreement on the lease between the Institute and the new operating company, must be at complete arms length with no overlapping of officers or directors.

16. All transactions must be entirely revealed, with all pertinent information, agreements, understandings, oral or otherwise, supplied to the Treasury Department, which has over a period of years, passed many transactions generally patterned on this outline.

17. Under this pattern, the income of the Institute is tax exempt. Also, if not more than 30% is paid to the seller on the note in the first year, the transaction qualifies as an installment sale, and the taxes on the long-term capital gains resulting are due only in installments proportional to the amount paid on the note in any one year.

18. The Institute will recognize reasonable commissions or fees to be paid by the sellers to persons arranging the transaction.

19. Upon an agreement in principal, the Institute will put the plan in the form of a bona fide proposal, subject only to:

a) The usual and satisfactory investigation by our representatives on the ground. This would include an appraisal of fixed assets.

b) The ratification by the Board of Directors of the California Institute for Cancer Research.

c) An audited balance sheet and priced inventory.

214 ADVANTAGES OF SALE OF A GOING BUSINESS TO CALIFORNIA INSTITUTE FOR CANCER RESEARCH

Many owners of a closely held, successful business find it difficult to get any considerable part of the corporate profits into their personal possession, after providing for both corporate and personal federal and state income taxes.

Working with the California Institute for Cancer Research, we have been able to solve this problem for a number of owners of sound concerns, having a strong current position, and valuable fixed assets consisting of land, buildings and operating equipment, achieving the following for the sellers:

1. They can sell their business to the Institute for more than they can sell for cash, for payment over a period of years, frequently with a substantial down payment.

2. They continue to control the business operation and to draw their regular salary, and retain an interest in the profits as well, until they are ready to retire.

3. They pay only a long term capital gains tax (26% federal).

4. They protect their families from estate, inheritance and final income taxes, which, with their chief assets still invested in the company, would have been ruinous.

5. They avoid the perplexing predicament of either paying prohibitively high personal taxes on distributed corporate earnings, or risking heavy penalties under Section 102 for unreasonable accumulation of surplus if earnings are not distributed.

6. They eliminate the risk that after the death of owners, the business may be subjected to a forced sale or liquidated at possible disastrous loss to their families.

7. They avoid the risk of the business being ruined by incompetent management if sold to others for payment on an installment basis, before the owners have been paid in full.

Our firm is in a position to tell owners how they can go about arranging such a sale, the full details of the transaction, more about the benefits, with the special advantages applicable to the particular situation, *without cost to the owners.*

215 Owners wishing to explore this program, can consult us in strictest confidence. All we ask is their

promise to continue to work only with us until they determine definitely whether or not they will sell at the price and terms obtainable.

The following information is needed:

1. Nature of business.
2. The balance sheet net worth.
3. Your estimate of actual net worth.
4. Estimated earnings before taxes for the current fiscal year.
5. Average net earnings before taxes for at least the past three years (for ten years, if available).
6. Current assets.
7. Current liabilities.
8. Cash and marketable securities (or other properties).
9. Book value of fixed assets.
10. Estimated present value of fixed assets.

LOUIS H. SEAGRAVE
Corporation Finance

216 CHECK LIST FOR QUALIFYING DEALS FOR SUBMISSION TO NON-PROFIT CORPORATIONS

1. The ownership must be in the hands of a few individuals and their families, unless an arrangement can be effected by deposit of stock or otherwise for assuring the deal of ownership.

2. The business must have been operating for a number of years and show the effects of good ownership and sound management.

3. The business must have a strong and liquid net current position.

4. The business must own valuable fixed assets constituting, at appraised values, substantially more than 50% of the purchase price.

5. Land and buildings must be included in the fixed assets and should constitute 50% or more of the fixed assets.

6. The management must be continued for at least a five year period in the operation of a new operating company, and effective steps must be taken to insure the continuity of good management.

NOTES:

A) The new operating company may be formed with a small operating capital since the Institute will, if requested, subordinate its note from the lessee company to reasonable bank loans and to ordinary business creditors.

B) The sellers may, as a group, including members of their immediate families, own a minority of the stock of the new lessee company.

C) The tax free status of the transaction limits the period of a lease to five years under existing Internal Revenue regulations.

D) All commission must be paid by the sellers and will ordinarily amount to 5% of the amount for which the business is sold.

217 ASSUMPTIONS

1. Seller sells all stock of operating company to Institute for $1,000,000, for which Institute gives note, secured by real and chattel mortgages.

2. Operating company is dissolved.

3. Payment at closing on purchase by Institute of $100,000 from assets received in dissolution.

4. Institute sells current position to new lessee company for $475,000 for which it receives note of lessee company, which is also deposited with seller to secure its note to seller.

5. New lessee company is capitalized for $25,000, of which seller buys 45% of stock and balance, or controlling interest, is purchased by friends (not family) of seller.

6. Seller is General Manager of new lessee company.

7. Earnings of new lessee company estimated at $300,000 per annum before taxes.

218 ASSUMED ANNUAL PAYMENTS ON PURCHASE

Net before taxes of lessee company	$300,000
20% retained by lessee company	60,000
80% paid to Institute as rent	$240,000
10% of rent retained by Institute	24,000
Paid to seller	$216,000

219 ASSUMED PAYMENT SCHEDULE

Price	$1,000,000
Payment at closing	100,000
	$ 900,000
1952 Payment	216,000
Balance Due	$ 684,000
1953 Payment	216,000
Balance Due	$ 468,000
1954 Payment	216,000
Balance Due	$ 252,000
1955 Payment	216,000
Balance Due	$ 36,000
1956 Payment	36,000

Note: Average net earnings of $300,000 by lessee company would pay out in 4 years and 2 months.

Payment in first year must not be in excess of 30% of sales price, or $300,000, to qualify sale as an installment payment transaction.

220 EARNINGS PER ANNUM OF LESSEE OPERATING COMPANY

(Assumed Capital $50,000)

Net before rent and taxes	$300,000
Rent	240,000
Retained	$ 60,000
5 year's net earnings before taxes	$300,000
Assume average 50% taxes on $60,000 per annum	150,000
Balance	$150,000
Long term capital gain tax when lessee corporation dissolved	37,500
Net gain after capital gains tax in 5 years	$112,500

450% earned on $25,000 capital in 5 years
90% earned on $25,000 capital annually

Net gain after taxes in next 5 years on basis of rental reduced to 60% of net earnings	$225,000
Net gain for 10 years	$337,500

1350% earned on capital in 10 years
135% average earnings on capital annually

(The above calculated gain is in addition to salaries paid to managers of lessee company.)

221 ASSUMED STATUS OF SELLERS

Sales Price of stock of company	$1,000,000
Cost	400,000
Profit	$ 600,000
Long Term capital gain tax	150,000
Net profit after taxes	$ 450,000
5 year net earnings after taxes on 45% of stock of new lessee companies when dissolved (assuming $300,000 net earnings per annum)	50,625
	$ 500,625
Second 5 year net of lessee company	$ 101,250
Net gain after taxes	* $ 601,875
Add back cost of property	400,000
	$1,001,875

(* Not including salaries and expense reimbursement)

222 PRO-TEM INITIAL STATEMENT OF NEW LESSEE CORPORATION, AFTER ACQUISITION FROM INSTITUTE OF CURRENT POSITION OF OLD OPERATING COMPANY

ASSETS

Current Assets:

Cash	$ 25,000
Receivables	250,000
Inventory	525,000
Total Assets	$800,000

LIABILITIES	
Current Liabilities:	
Accounts Payable	$300,000
5-year note to Institute for current position	475,000
Capital	25,000
Total	$800,000

223 **Exhibit 25-Y**

(Received Dec. 18, 1952. Clay Brown & Company)

MAdison 6-1381

LOUIS H. SEAGRAVE
840 General Petroleum Building
612 South Flower Street
Los Angeles 17, California

December 17, 1952

Mr. Clay Brown
President
Clay Brown & Co.
U. S. National Bank Bldg.
Portland 4, Oregon

Dear Mr. Brown:

During the past week I have gone over my notes and papers you supplied me, and talked with some of the officers of the California Institute for Cancer Research.

All of us are impressed with your company and the kind of management you are giving it. We would like very much to see it acquired by the Institute.

Our difficulty is the price, or to put it another way, we feel that a $250,000 premium over reconstructed values is perhaps all a purchase will stand, especially since average earnings before taxes of $360,000 would be required to pay off a price of $1,300,000. Earnings of $360,000 per annum are a little higher than your own idea of $350,000. Incidentally, earnings before taxes for the two and one-half years to October 31, 1952 averaged about $300,000 per anuum, but if we were to add back to the year ended April 30, 1952 the amount of $150,000, which would prob-

ably not be far from the amounts charged to expense for items which could have been capitalized, and assume net earnings for the current year would aggregate $350,000 the three-year average would be about $350,000.

On the other hand, there is another angle not to be overlooked, namely, the prospective earnings of the new lessee company, in which stockholders of the present company could own nearly 50%. Assuming net before taxes of $350,000, earnings per annum of the new company after payment of rental would be $72,000. Assuming that income taxes for such an amount of earnings average 33 1/3%, the net to surplus would be $48,000 a year or $240,000 for the five years period.

224 The net equity accruing to the 49% interest in the new lessee company would amount to $117,000 additional. This would increase the total proceeds of the sale to $1,417,000, which is the equivalent of $44.28 a share.

So far as I know, the Internal Revenue Department has never objected to ownership by the sellers and their families of a *minority* interest in the new lessee company. Our counsel, Paul R. Coté, who was the lawyer who originated the formula we follow in such purchases, says that a minority interest cannot, under the statutes and tax rulings, be regarded as control, and hence cannot be the base for an attack on the theory that the seller is "doing business with himself." Always providing, of course, that neither the sellers or members of any of their families, are directors or statutory officers of the new lessee company.

If your counsel has reservations about this, I wish he would talk to Paul R. Coté, or write to him. His phone numbers are Bradshaw 25177 (Los Angeles exchange) and Crestview 13146 (Beverly Hills exchange). His address is 118 S. Beverly Drive, Beverly Hills.

We've given a good deal of thought to the possibility of making a purchase of timberland and stumpage, which Clay Brown & Co. contracted to cut and process over a period of years. Not only would it apparently be a good protection to you, but should result in substantial profits. A certain source of, say, half of your logs each year would enhance our ideas of the value and payout of purchase of Clay Brown & Co.

If you carry out your intention of returning to Eureka December 22nd for the Christmas holidays, I profoundly hope you will find an opportunity of pressing that phase of the matter.

My best regards.

Sincerely yours,

(Signed) L. H. Seagrave

LHS:HL

225 **Exhibit 26-Z**

(Received Dec. 19, 1952. Clay Brown & Company)

MAdison 6-1381

LOUIS H. SEAGRAVE
840 General Petroleum Building
612 South Flower Street
Los Angeles 17, California

December 17, 1952

Mr. Clay Brown
President
Clay Brown & Co.
U. S. National Bank Bldg.
Portland 4, Oregon

Dear Mr. Brown:

We would appreciate your having a copy sent me of your complete audited statement for April 30, 1952. As you may remember, we have only the balance sheet and profit and loss statement for that date.

Would you also ask Mr. Booth to make up for us a pro-forma balance sheet for October 31, 1952, substituting the values we talked about. I think he said that his calculation gave a net worth of about $1,050,000 based on appraisals and other items, whereas I got only $1,000,000. I know I overlooked something, and the easiest way to get it right would be to use the same figures he has; marginal notes or a list showing the additional items and amounts would also be helpful.

Sincerely,

(Signed) L. H. Seagrave

LHS:HL

December 22, 1952

Mr. Louis H. Seagrave
840 General Petroleum Building
612 South Flower Street
Los Angeles 17, California

Dear Mr. Seagrave:

Mr. Brown has left for the mill and before going he handed me your letter of December 17th, asking that I compile and send the information requested.

Under separate cover I am sending you a signed audited statement prepared by Peat, Marwick, Mitchell & Co. dated April 30, 1952. This accounting firm made a complete audit including inventory observation as of April 30, 1952 but prepared only the short form of statement enclosed. We requested that they prepare only this abbreviated form since it would be less expense for us and we felt this would take care of our requirements. Should you require supplemental detail for this same period, we can submit it to you unaudited from our own work sheets and would be glad to do so. Our monthly statements regularly include, in addition to the statement of income and the balance sheet, the following:

Statement of Cost to Manufacture
Detail of Direct Charges and Mill Overhead
Summary of Direct Charges and Mill Overhead
Summary of Selling and Administrative Expenses
Accounts Receivable
Accounts Payable

If you wish any of the above supplemental sheets as of April 30, 1952, please advise and we will send them to you promptly.

I am now in the process of compiling information and preparing a pro forma balance sheet as of October 31, 1952 substituting the revised values. Quite likely this will be in the mail to you be tomorrow.

Mr. Brown requested that I ask you if you would be willing to supply us with the names of any other firms with whom the Institute has completed negotiations such

as we are currently considering. We, of course, are
227 familiar with the Timber Structures deal but are wondering if there are others which were consummated somewhat earlier and which perhaps by now have been examined by the Internal Revenue Bureau. If so, we would like the opportunity of talking with the principals of such companies and this would be especially helpful if they happen to be in the lumber or wood products industry.

I understand that our attorney, Mr. Souther, planned to talk to Mr. Coté today although I have not yet heard whether the call was completed and if so what information Mr. Souther gleaned from the conversation.

Yours truly,

CLAY BROWN & COMPANY
C. W. Booth
Secretary-Treasurer

CWB/bs
cc:CB

228 (Received Jan. 8, 1953. Clay Brown & Company)

MAdison 6-1381

LOUIS H. SEAGRAVE
840 General Petroleum Building
612 South Flower Street
Los Angeles 17, California

January 7, 1953

Mr. C. W. Booth
Secretary-Treasurer
Clay Brown & Company
U. S. National Bank Bldg.
Portland 4, Oregon

Dear Mr. Booth:

I am sorry to be so long in answering your letter of December 22nd but the holidays and several absences from the city put me a long way behind in my correspondence.

First of all I received the audited statement of Peat, Marwick, Mitchell & Co., dated April 30, 1952, for which I thank you. I should like, also, to have the supplemental

details for that same date in the unaudited form, including the six schedules you mentioned in your letter of December 22nd, which you kindly volunteered to send me.

The ProForma Statement of Assets of October 31, 1952, in which the revised values were substituted, and the itemized schedule B, which makes the substitutions entirely clear, were also received and very much appreciated.

As to companies with which deals have been completed, my suggestion is that the one of most interest to you would be that of the White Pine Lumber Company in Reno, Nevada, which was sold to Loyola University and handled by Paul Coté. Probably you or Mr. Brown know the principals connected with that company.

Another suggestion is the name of Dana Latham, a leading tax attorney in Los Angeles, whose present offices are in the Statler Building, 900 Wilshire Blvd.,
229 Los Angeles. He has been familiar with this type of transaction for a good many years, and I believe, with Mr. Coté handled the sale of the U. S. Grant Hotel, as well as the more recent sale of the Allied Recorder Company. He is also counsel for another company, the name of which I am not yet free to give you but it may be that you or your lawyers would like to contact him and ask him a few questions. I understand from Mr. Coté that Mr. Souther did talk to him, in particular concerning the ownership of a new operating company.

I am of the opinion that it would be, as you suggest, a good idea to bring the appraisal up to date, if we arrange a basis for a deal. I hope it will not be too expensive. Thank you very much for your careful attention to my requests.

I will not be in the office after Friday, and will be in Portland the fore part of next week, so you may as well hold the supplementary sheets to your company statement of April 30, 1952, and hand them to me when we meet in Portland.

You probably now have the company statement for November 30th and may have some preliminary idea of results for December. These figures, of course, I would like to know though I realize that these months, and Decem-

ber in particular, are off-season and that the earnings for this half year will probably occur in the first four months of this fiscal year.

Kindest regards.

Sincerely yours,

(Signed) L. H. Seagrave

LHS:HL
cc: Mr. Clay Brown

Exhibit 28-BB

230

December 23, 1952

AIR MAIL.
Mr. Louis H. Seagrave
840 General Petroleum Building
612 South Flower Street
Los Angeles 17, California

Dear Mr. Seagrave:

We attach hereto two schedules—the first, a statement of assets showing adjusted values as of October 31, 1952 and the second, which we have labeled "Schedule B", showing how we have arrived at these values.

You will note the adjusted fixed assets amount to $1,005,068 and in addition there is an item of $25,000 consisting of supplies which we have included in the current assets, making a total adjusted value of $1,030,000. We have not prepared a liability side of the October adjusted balance sheet since the only changes would be in the earned surplus and the accrual for income and excise taxes. It is difficult, if not impossible, to determine just what portion of the $423,750 should be allocated to each of those two accounts.

In preparing Schedule B we started with the appraisal prepared by General Appraisal Company in July, 1951 and Mr. Brown tells me you have the recapitulation from the mill copy of this appraisal so that you can readily identify the first column of figures. In the second column of figures we have reduced two items since the General Appraisal Company included among our assets a crane and some fork lift trucks and straddle carriers which the company leases and does not own.

As we mentioned to you over the telephone, the appraisal did not include land value; and a further analysis reveals the appraisal does not include a logging arch which was working in our timber at the time the appraisal was taken and apparently was overlooked. In addition there are four executive automobiles plus some trucks and a station wagon which were not listed in the appraisal; nor did the appraised figures include furniture and fixtures and office equipment in Portland and San Francisco and in our Eureka apartment.

The third column lists items which were expensed in our books but which added to the value of the properties. You will note this column totals $63,000 which is approximately the figure that you and Mr. Brown and Mr. Hill agreed was reasonable for lumber, labor and other expensed items when you discussed this feature at our mill. The total indicated here is approximately $20,000 less
231 than the $1,050,000 we indicated in our telephone conversation, and the original figure was based on calculations made rather hurriedly. Even so, we feel that the figure herein presented is conservative and a revised appraisal might easily bring this up to or beyond the $1,050,000 figure we gave you on the telephone. We should think that it might be worthwhile to bring the appraisal up-to-date although, of course, there would be some expense involved in doing this.

We hope this gives you the information you need; but if you should require anything further or a more detailed explanation of any of the items listed, please let us know and we will attempt to get you whatever you need.

Yours truly,

CLAY BROWN & COMPANY
C. W. Booth
Secretary-Treasurer

CWB:bs
cc:CB
Enc.

	Per Statement Oct. 31, 1952		Estimated Increases in Value		Adjusted Values Oct. 31, 1952	
Cash		$ 9,364				$ 9,364
Accounts & Notes Receivable, less allowance for doubtful accounts:						
Trade (less freight)	$173,459					
Sundry & Notes Receivable	2,390					
	175,849					169,758
Allowance for doubtful accounts	6,091	169,758				
Inventories:						
Logs	538,353					
Lumber	60,607					
Supplies	—	598,960		$ 25,000		623,960
Prepaid Expenses:						
Falling & Bucking	1,606					
Insurance	11,088	12,694		—		12,694
TOTAL CURRENT ASSETS		790,776		25,000		815,776
Property, Plant & Equipment:						
Land	24,635		$ 38,935		$ 63,570	
Buildings, Equipment & Facilities, Automotive, Yard & Logging Equipment, Furniture & Fixtures	613,566		182,827		796,393	
Total Fortuna Plant	638,201		221,762		859,963	
Sales & Executive Offices:						
Automobiles	13,015		(3,015)		10,000	
Furniture & Fixtures	7,376		4,729		12,105	
	658,592		223,476		882,068	
Less allowance for depreciation	103,201		103,201			
	555,391		326,677		882,068	
Timber, less depletion	50,927	606,318	72,073	398,750	123,000	1,[illegible],068
Deposits & Deferred Charges to Operation		4,188				4,188
		$1,401,282		$423,750		$1,825,032

SCHEDULE "B"

233

	Value per Appraisal July, 1951	Plus items Capitalized since July, 1951 or not included in appraisal	Plus items expensed	Total Value
Mill "A"—Construction	$ 33,995		$ 1,038	
Mill "A"—Equipment	138,386	$ 25,451		
Resaw & Green Chain extension		4,386	16,255	
Sprinkler system		2,867		$ 222,37
Mill "B"—Construction	39,240	253		
Mill "B"—Equipment	117,418			
Paint & Painting		2,213	1,028	
Band Mill & Filing Room		4,625	5,000	169,77
Planing Mill—Construction	13,236		142	
Planing Mill—Equipment	61,449			74,82
Shop—Construction	5,898			
Shop—Equipment	6,556	591 (a)		13,04
Carrier Garage—Construction	4,540		4,600 (b)	
Carrier Garage—Equipment	36,810	(28,250) (c)		
Trucks and Station Wagon		7,000 (c)		24,70
Trim Saw Shed—Construction			2,500 (d)	2,50
Drag Saw & Tool Sheds, Oil & Store house & Power service shed:				
Construction	3,151			
Equipment	8,413			11,56
Toilets—Construction	746		960 (e)	
Toilets—Equipment	11		1,116 (e)	2,83
Log Scaler & Unloader sheds—Construction	757			
Log Scaler & Unloader sheds—Equipment	2,549		4,801 (f)	8,10
Log Scaler platforms & shack				
Fire pump house—Construction	4,478			
Fire pump house—Equipment	16,501			
Pump & Hose Houses—Construction	1,252			27,64
Pump & Hose Houses—Equipment	5,375			
Office—Construction	15,126			20,77
Office—Equipment	5,648			
Yard—Construction	12,991		5,712 (g)	
Yard—Equipment	172,931	(43,350) (h)		150,19
Concrete at load dock & chains			1,911 (i)	15,00
Sundry lumber, labor & other items			15,000 (j)	53,08
Pond—Construction	53,088			63,57
Land—42.38 Acres @ $1500		63,570		
Furniture & Fixtures—Portland, San Francisco & Eureka		9,104 (k)	3,000	12,70
4 Automobiles at estimated present value		10,000		10,00
Timber—15MM @ $8.20		123,000		123,00
	$760,545	$181,460	$63,063	$1,005,06

SCHEDULE "B" Continued

(a) Steam cleaning outfit.

(b) Garage was doubled in size after date of appraisal.

(c) Appraisal included lift trucks and lumber carriers not owned by Clay Brown & Company but leased, and did not include dump truck, two pickup trucks and a station wagon which were owned.

(d) New since appraisal.

(e) Two new toilets with septic tanks built recently.

(f) New since appraisal.

(g) Gravel for yard and dikes; raising spur track and additions to fences and auto gate.

(h) Appraisal included Osgood Crane not owned but leased. Did not include logging arch owned and valued at $4000.

(i) Concrete at loading dock and around sorting chains.

(j) Mostly applicable to sawmill buildings.

(k) At book value 11/30/52.

EXHIBIT
31-EE

APPRAISEMENT

of

[redacted]

Located at

[redacted]

by

General Appraisal Company

Incorporated

Valuation Engineers

SAN FRANCISCO
74 NEW MONTGOMERY ST.

SEATTLE
408 MARION ST.

LOS ANGELES
208 WEST EIGHTH ST.

PORTLAND
TERMINAL SALES BLDG.

236 INTRODUCTION

Portland, Oregon
January 14, 1953

Clay Brown & Company
Fortuna, California

Gentlemen:

In accordance with your instructions, we herewith present our Summary Appraisement, as of the above date, of certain physical assets as follows:

Clay Brown & Company
Fortuna, California

This summary is based upon an itemized detailed appraisal as of the date of July 21st., 1951. Percentage of increase in market values and depreciation to the present date have been taken into consideration in preparing this report. The various items herein valued have been pointed out to us as your property and the question of "title" to these items has not been included in our investigation.

Itemized details of this appraisement are on file, subject to owners directions, at the office of the General Appraisal Company, 209 Terminal Sales Bldg., Portland, Oregon.

The Preface to the appraisement immediately following outlines the method of procedure and the basis of valuation. It has been a pleasure to be of service to you in this matter.

Very truly yours,

GENERAL APPRAISAL COMPANY
By Roy A. Dean, President

237 PREFACE TO APPRAISEMENT

Listing Method

The detailed information contained in this report has been obtained by a personal inspection of the subject property. Where buildings, tenants' improvements, or other items of construction are involved, the component parts have been listed in detail and segregated according to standard construction classifications. Where machinery

and equipment are involved, an item-by-item listing has been completed. Arrangement is by appropriate classification, location or department. Installation, belting, piping, wiring, millwrighting and other appurtenant items have been listed with each machine or classification. This listing method facilitates the ready determination of the value of each machine or production unit.

New Replacement Value

New replacement cost of the various items of construction and equipment has been determined as of the date of this appraisement on the assumed basis of replacing the entire property as a complete unit at one time. In determining the reproduction cost of each item of construction and equipment we have used current local prices including freight and cartage, applicable labor rates for a 40-hour week, normal contractor's profit and overhead, architectural and engineering costs, contingent costs, insurance and other indirect costs incidental to actual construction of the building or installation of equipment as appropriate. It has been assumed that suitable materials are available and can be delivered without unusual delay. No allowance has been made for unusual labor overtime or inefficiency, nor for change orders during construction or installation.

Depreciated Value

Depreciated value, or in insurance terms "actual cash value," represents the present value as judged by a comparison of actual physical condition and currency of each item or unit with new items or units of like kind and quality. The depreciated value of any item may be defined as the remaining service value plus the salvage value. Depreciated value also reflects factors such as obsolescence, supersession, maintenance, and lack of utility. Depreciation may be offset in part by the renewal of parts or by partial reconstruction. Depreciated value represents our opinion of the value of such property predicated upon the assumption that it is operated under competent management by a profitable going concern.

238 Clay Brown & Co.

RECAPITULATION

January —, 1953

	New Replacement Value	Depreciated Value	Excluded Value	Insurable Value
Saw Mill "A"				
Construction	35,850.83	32,229.41	2,665.55	29,563.86
Equipment	172,389.51	145,726.02	2,431.29	143,294.73
Mill "A" Sorting Shed				
Construction	8,764.61	7,916.51	233.66	7,682.85
Equipment	18,226.20	16,042.62	109.27	15,933.35
Saw Mill B				
Construction	46,307.43	42,866.80	2,284.98	40,581.82
Equipment	146,236.18	121,513.54	424.74	121,088.80
Mill B Sorting Shed				
Construction	4,413.09	4,063.31	90.80	3,972.51
Equipment	5,466.90	4,922.66		4,922.66
Planing Mill				
Construction	15,239.54	13,912.78	869.33	13,043.45
Equipment	63,415.33	49,452.50	179.19	49,273.31
Misc. Bldgs.				
Shop				
Construction	6,282.86	5,787.16	566.92	5,220.24
Equipment	7,958.08	5,761.07		5,761.07
Carrier Garage				
Construction	4,720.45	4,339.60	598.64	3,740.96
Equipment	7,904.97	3,826.10	+ 3,594.50	3,826.10
Saw Shed				
Construction	1,428.76	1,357.33		1,357.33
Equipment	1,212.20	969.76		969.76
239				
Drag Saw Shed				
Construction	864.92	648.70		648.70
Equipment	1,211.84	959.44		959.44
Toilets #1 & #2				
Construction	1,596.48	1,396.92		1,396.92
Equipment	10.94	7.66		7.66
Oil House				
Construction	1,143.59	1,029.23	100.21	929.02
Equipment	111.05	94.39		94.39
Power Service Shed				
Construction	990.99	891.89	93.74	798.15
Equipment	6,991.08	6,152.15		6,152.15
Tool Shed				
Construction	203.65	173.10		173.10
Equipment	171.56	128.67		128.67
Store House				
Construction	168.45	143.19		143.19
Log Scaler Shed				
Construction	527.48	395.61		395.61
Equipment	89.01	66.76		66.76

RECAPITULATION, Cont'd.

	New Replacement Value	Depreciated Value	Excluded Value	Insurable Value
Misc. Bldgs. Cont'd.				
Log Unloader Shed				
Construction	282.93	226.35		226.35
Equipment	2,597.28	1,947.96		1,947.96
Pump House #1				
Construction	218.01	196.21		196.21
Equipment	1,872.61	1,647.89		1,647.89
240				
Pump House #2				
Construction	218.01	196.21		196.21
Equipment	1,872.61	1,647.89		1,647.89
Pump House #3				
Construction	286.53	272.21	3.94	268.27
Equipment	589.01	559.55		559.55
Fire Pump House				
Construction	4,638.68	4,431.85	779.75	3,652.10
Equipment	17,084.61	15,316.86	357.62	14,959.24
Hose House #1				
Construction	141.45	124.48		124.48
Equipment	164.83	145.05		145.05
Hose House #2				
Construction	141.45	124.48		124.48
Equipment	314.58	289.42		289.42
Hose House #3				
Construction	141.45	124.48		124.48
Equipment	402.46	370.26		370.26
Hose House #4				
Construction	141.45	134.38		134.38
Equipment	152.54	141.86		141.86
Hose House #5				
Construction	48.87	43.01		43.01
Equipment	291.34	268.04		268.04
241				
Office				
Construction	15,942.83	14,565.14	370.66	14,194.48
Equipment	6,137.91	5,329.14		5,329.14
Yard				
Construction	13,511.28	10,975.76	+ 1,779.06	8,734.97
Equipment	156,581.28	118,643.81	{ 2,238.79 / 50,698.13 }	67,950.66
Pond			+ { 35,293.70 }	
Construction	53,088.45	53,021.71	52,790.05	231.66
Arch (listed as crane)			3,191.32	
Total Construction	217,304.52	201,587.81	63,687.02	137,900.79
Total Equipment	619,454.91	501,936.07	54,200.24	447,735.83
Total addn's to exclusions			add 41,265.90	less 41,265.90
Grand Totals	836,759.43	703,523.88	159,153.16	544,370.72

242 Exhibit 32-FF

PURCHASE AGREEMENT

This Purchase Agreement, made and entered into at Portland, Oregon, this 4th day of February, 1953, by and between Clay Brown of Portland, Oregon, acting for and on behalf of himself and all of the other stockholders of Clay Brown & Co., an Oregon Corporation, namely: Dorothy E. Brown; Donald Brown; Philip Brown; Marilyn Brown; C. A. Hill; Nancy H. Booth and C. W. Booth; hereinafter referred to as "Seller", and California Institute for Cancer Research, a California non-profit corporation, hereinafter referred to as "Buyer":

WITNESSETH:

That for and in consideration of their respective agreements hereinafter set forth, Seller and Buyer hereby agree, each with the other as follows:

I.

That as of the date of this agreement, Seller has sold, assigned, transferred, and delivered to and does hereby sell, assign, transfer and deliver to Buyer all, to-wit: 32,000 shares of the issued and outstanding capital stock of Clay Brown & Company, an Oregon corporation, hereinafter referred to as "Brown & Co." Seller has likewise sold, assigned, transferred and delivered, and does hereby sell, assign, transfer and deliver, without recourse, to the Buyer, two (2) promissory notes owned by Clay and Dorothy E. Brown and executed by Brown & Co., the total principal amount of said promissory notes being $125,000.00 (which notes shall hereinafter be referred to as the Brown notes). Clay and Dorothy E. Brown agree to waive any interest that may accrue on the Brown notes subsequent to the date of this agreement.

II.

The purchase price of said stock and notes re-
243 ferred to in paragraph I above which Buyer shall pay to Seller in the manner and at the times and from the sources hereinafter set forth, is $1,300,000.00, subject to revision as hereinafter provided in paragraphs III and XX. Said purchase price shall be evidenced by a non-negotiable promissory note, subject to payment as

herein provided for, in the amount of $1,300,000.00, without interest, signed by the Buyer (which note shall hereinafter be referred to as the principal note).

III.

An audit of the books, records and accounts of Brown & Co. will be prepared by Seller's accountants, Peat, Marwick, Mitchell & Company of Portland, Oregon, as of the close of business on January 31, 1953 (hereinafter referred to as the 1953 audit), and said audit shall be subject to the approval of Buyer or any Certified Public Accountant selected by Buyer. Seller, concurrently herewith, has furnished to Buyer a balance sheet and profit and loss statement for Brown & Co. as of October 31, 1952, and Seller warrants and represents that said Balance Sheet and Profit and Loss Statement so furnished accurately reflect the financial condition of Brown & Co. at the date of this agreement, except as to such changes therein as have resulted from the normal and usual operation of the business of Brown & Co. from the first day of November, 1952, to the date of this Agreement, and that said audit to be prepared by Peat, Marwick, Mitchell & Company will reflect only such changes. If for any reason it should become necessary to set up a tax reserve in excess of the amount of tax reserve set up in the certified audit, then the excess of said reserve shall result in a reduction of the principal note by the amount of such excess. Neither the statement dated October 31, 1952, nor the audit prepared as of the close of business on January 31, 1953, shall show or reflect any reserve for re-negotiation. If, in the future, any liability should be established by reason of re-negotiation on any contract previously entered into by Brown & Co. which is subject to re-negotiation under the provisions of the Federal law, then and in said event, the amount of such liability resulting from said re-negotiations, and which affect profits earned prior to January 31, 1953, will likewise reduce the amount of the principal note as set forth in paragraph II of this agreement.

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IV.

Buyer shall liquidate and dissolve Brown & Co. forthwith upon the delivery of said shares of stock by Seller

to Buyer, and all of the assets of Brown & Co. shall be distributed in liquidation to Buyer as a liquidating dividend.

V.

Buyer, immediately upon liquidation and distribution of the assets of Brown & Co. shall:

(a) Pay $5,000.00 in cash to Seller upon the principal note; and

(b) Execute a lease and license agreement (hereinafter referred to as the lease) with Fortuna Sawmills, Inc. (hereinafter referred to as Lessee), which lease shall license and lease to Lessee the name, good will, patents, patent applications, trademarks and all of the fixed assets received by Buyer from the liquidation of Brown & Co. upon the terms and conditions set forth in Exhibit "A" attached hereto and made a part hereof by reference; in the event the lease shall for any reason terminate Buyer shall use its best efforts to forthwith re-lease and re-license the property to a new lessee under a similar lease and the term "lease" used herein refers also to such subsequent lease, if any; and

(c) Sell to Lessee all of the assets received by Buyer upon the liquidation of Brown & Co., excepting the sum of $5,000.00 in cash and the assets described in the lease, upon the following conditions:

Lessee shall agree in writing to assume, and pay when due, out of the assets so purchased, all of the current and deferred expenses, obligations, and liabilities of Brown & Co., as shown on the 1953 audit, excepting the Brown notes; and

Said written assumption agreement of the Lessee
245 shall also provide for the payment by Lessee to the Buyer out of the assets so purchased of the amount by which the total amount of the assets so purchased exceeds the total liabilities and obligations so assumed; and this obligation of the Lessee to pay such excess shall be evidenced by a promissory note due and payable on or before five years from the date of this agreement, without interest, but with an acceleration clause in event payor defaults in the payment of any of said liabilities assumed by Lessee as above set forth (which promissory note shall hereinafter be referred to as the purchase note). The

assets so purchased shall be sold at the book value thereof as disclosed by the 1953 audit. In event that it shall become necessary for the Lessee to obtain independent financing or credit, and in order to do so, it shall be required to obtain the subordination of the purchase note to said financing or credit, then Buyer agrees to so subordinate the purchase note.

VI.

Buyer shall pay to Seller ninety (90%) per cent of all royalties or rents received in cash by Buyer from the Lessee under the lease until the remaining balance of the principal note has been paid in full; provided, however, that the entire balance of the principal note, if not sooner paid, shall be due and payable on the 31st day of January, 1963. The unpaid balance of the principal note shall bear no interest until maturity, but thereafter shall bear interest at the rate of five (5%) per cent per annum.

VII.

Seller shall have the right, at his option, to accelerate the entire unpaid balance of the principal note in the event that the Buyer shall fail to pay the Seller a total of Two Hundred Fifty Thousand Dollars ($250,000.00) during any two consecutive years of the term of the lease. For the sole purpose of determining whether the right to accelerate exists under the preceding paragraph, there
246 shall be added to the cash amounts so paid, the aggregate amounts incurred for capital improvements or additions in said two consecutive lease years with the prior written consent of the Buyer.

VIII.

Buyer shall be obligated to make payment of the principal note only out of 90% of the royalties and rental received by Buyer from the Lessee under the lease and out of the proceeds from sales, if any, of the assets leased or licensed to the Lessee as hereinafter permitted.

IX.

In event that either Buyer or Lessee shall use all or any of Lessee's profits or the rental or royalty paid to Buyer under the lease, to pay any liability or obligation of Brown & Company as disclosed by the 1953 audit, or

any liability covered under the Indemnity Agreement of Seller under paragraph XX of this Agreement, they or any of them shall be entitled to do so, and any such application by Lessee out of Lessee's profits or by the Buyer out of said rental or royalty, shall not be a default by the Lessee under said lease, or by the Buyer in its obligations hereunder, or under the principal note; and if the amount so used is used to pay liabilities or obligations as disclosed on said 1953 audit, the amount shall not be applied on the principal note; but if the amount so used is applied on any liability covered under Indemnity Agreement of Seller under paragraph XX of this agreement, then the amount so used shall be applied on the principal note.

X.

The sale of all or any of the assets (other than fixed assets) by Buyer to the Lessee is hereby approved by Seller on condition that the full proceeds representing the excess of the assets so sold over the obligations or liabilities of Brown & Co. assumed by the Lessee will be paid by Buyer to Seller within five (5) days after
247 receipt thereof in cash by Buyer from the Lessee and shall be applied by Seller upon the principal note.

Buyer shall not be deemed to have received payment from the Lessee until said payment is received in cash. The acceptance of a note or notes evidencing said indebtedness of the Lessee for the purchase price of such assets shall not be deemed to be a payment of the amount thereof to Buyer, but any such note or notes shall be assigned by Buyer to Seller as additional security for the payment by Buyer of the principal note.

XI.

No sale by Buyer of any assets received by Buyer on dissolution of Brown & Co., other than those sold to the Lessee pursuant to the provisions of paragraph IX above shall be effected without the prior written consent of Seller theretofore having been first had and obtained.

XII.

In the event that Buyer shall default in any of the obligations under the provisions of this agreement, Seller may, at his option, and without notice or demand to Buyer,

declare the entire remaining balance of the principal note immediately due and payable, and if such balance is not so paid, Seller may proceed to enforce payment against the collateral held by Seller as security, but out of said collateral only.

XIII.

All payments made by the Buyer to Seller shall apply, first: seventy-five (75%) per cent on the purchase price of the Brown notes, which purchase price for the Brown notes shall be deemed and considered as the face amount thereof; and twenty-five (25%) per cent on the purchase price of said stock. Upon the payment in full of the Brown notes, then all payments made by the Buyer to Seller shall apply on the purchase price of the stock.

XIV.

Concurrently with the execution of this agreement
248 and the liquidation of Brown & Co. and the acquisition of the assets of Brown & Co. by Buyer upon liquidation, and also upon the acquisition of any additional fixed assets as herein provided, Buyer shall execute and deliver to Seller, properly executed to permit recordation thereof, a real estate mortgage or deed of trust on any real property, and a chattel mortgage on any personal property, acquired by Buyer upon the liquidation of Brown & Co., (except assets sold to the Lessee), and an assignment of the lease and the purchase note, to secure the payment by Buyer to Seller of the principal note at the time and in the manner herein required, and shall further execute and deliver a real property mortgage or deed of trust of any real property and a chattel mortgage of any personal property acquired by Buyer at any time as the result of this transaction, or the provisions of the lease as further security to Seller for the payment of the principal note.

Inasmuch as patents and patent applications and trademarks are not subject to chattel mortgage, Buyer agrees to assign said patents, patent applications and trademarks to Seller to further secure the unpaid balance of the principal note and said assignments shall be deemed and considered as defeasible assignments in the same manner as a chattel mortgage so that, upon the payment in full of the unpaid balance of the principal note by Buyer to

Seller, said patents, patent applications and trademarks shall be re-assigned by Seller to Buyer.

XV.

The payments to be made by Buyer to Seller out of rental as herein provided shall be so made within five (5) days after receipt by Buyer of each payment of such rental from the Lessee, and the payments to be made by Buyer to Seller out of the sale of any assets shall be so made within five (5) days after the receipt by Buyer in cash of the proceeds of the sale of any such assets.

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XVI.

For the purposes of this agreement, it is mutually understood and agreed that the words "net profits" upon which the rental to be received by Buyer from the Lessee is based, shall be construed to mean net profits before depreciation and before provision or deduction for income, franchise, excess-profits, or other similar taxes, computed in accordance with sound accounting practices by public accountants mutually acceptable to Buyer and Seller.

XVII.

At the time of the making of each payment to apply on the principal note, Buyer shall deliver to Seller the following documents appropriate thereto:

(a) A detailed statement of the amount of gross rental received by Buyer from the Lessee; and

(b) A detailed statement of the gross selling price, the expenses of sale, and the net proceeds of sale received by Buyer from the sale of assets determined on the basis provided in this agreement.

XVIII.

Buyer covenants and agrees to keep full, accurate and complete records reflecting all of the rental and proceeds from the sale of assets received by it until such time as the principal note has been paid in full to Seller. Said records and accounts, and all vouchers and statements upon which the same are predicated, shall at all times be subject and open to the inspection of said examination by Seller or his agent or representative.

XIX.

Seller, in addition to its representations and warranties as hereinabove set forth in reference to said audit to be prepared by Peat, Marwick, Mitchell & Company, hereby make the following representations and warranties and no others in connection with the purchase and sale of the assets and notes which are the subject of this purchase agreement.

(a) That Clay Brown & Company is a corporation duly organized and existing under and by virtue of the laws of the State of Oregon, and is duly qualified and is transacting business in the States of California and Oregon; that there is now issued and outstanding 32,000 shares, and no more, of the capital stock of said corporation; that said shares have a par value of $1.00 each; that all of said shares issued and outstanding are valid and were regularly and validly issued under and in compliance with the laws of the State of Oregon; that Seller has full right and authority to sell and transfer all of said shares purchased by Seller under this agreement; that all of said shares purchased by Buyer under this agreement are free and clear of all liens, encumbrances, obligations or pledges, and that no other persons have any right, title or interest in said stock other than Seller.

(b) That there will be attached hereto marked Exhibit "B" and by this reference made a part hereof, a Balance Sheet of Brown & Co. as of the close of business on January 31, 1953, prepared by Peat, Marwick, Mitchell & Company, which shall be a part of the audit as provided for in paragraph III above; that said Balance Sheet will accurately reflect the financial condition and net worth of Brown & Co. as of said date, and will correctly set forth all obligations and liabilitiles of Brown & Co. existing as of said date, and of whatever nature, contingent or otherwise, and either directly or by way lar taxes levied or assessed, or accrued, on or before the date of said Balance Sheet; that all of Brown & Co.'s franchise taxes, federal income and excess profits tax, social security and unemployment taxes, and retail sales and use taxes, and federal withholding taxes to and including the date of said Balance Sheet have been paid or

accrued, and if accrued, set forth on said Balance
251 Sheet; that Seller does not know of any taxes, liabilities, or assessments, whether or not assessments thereof have as yet been made, or any litigation not reported or shown on said Balance Sheet, and does not know of any ground upon which any deficiency taxes, assessments, penalties, or interest might be made, and does not know of any other claim, obligation or liability of Brown & Co. not shown on said Balance Sheet which may be assessed against Brown & Co., or which may result in litigation; that no litigation is now pending by or against Brown & Co. except as may be shown on said Balance Sheet; that said Balance Sheet to be prepared by Peat, Marwick, Mitchell & Company will reflect only such additional changes over the Balance Sheet of said corporation as of October 31, 1952, as may result from the normal and usual operation of business of Brown & Co.; that there are no leases or executory contracts of any kind or nature upon which Brown & Co. could have any liability except those shown on said Balance Sheet.

XX.

Seller agrees with Buyer, and for the benefit of Brown & Co., and the directors of Brown & Co. at the time of dissolution of Brown & Co. (which directors shall hereinafter be referred to as directors) that Seller shall and does hereby indemnify, save and hold harmless Buyer, Brown & Co., and directors of and from any assessment, taxes, penalties, interest, or liabilities of any kind or nature that may be levied or assess against or may be found to be due and owing from Brown & Co. excepting such as are shown in said Exhibit "B." Seller reserves the right to defend Buyer, Brown & Co. or directors at Seller's own expense against any taxes or other liability or other obligation covered by this Indemnity Agreement of Seller, but Buyer may, at Buyer's option, charge any unpaid liability of Seller, under this paragraph XX against any balance due Seller on said promissory notes. Seller's Indemnity Agreement shall likewise cover all losses, costs,
liabilities or expenses of Buyer, Brown & Co. or di-
252 rectors. Seller shall be notified promptly in writing of any claim for any such taxes, liabilities or obligations covered by Seller's indemnity which may be asserted

hereafter against either Buyer, Brown & Co. or directors. Nothing herein contained, however, shall be deemed or considered as affecting the provisions as to reserve for taxes, or re-negotiations as hereinabove set forth in paragraph III above, and any such increase in income or excess profits taxes or liabilities or re-negotiations shall not be deemed or considered under the personal warranty of the Seller, but shall effect only the purchase price as recited in said paragraph III.

XXI.

Any and all notices which Buyer may be required or may have the option of giving to Seller shall be delivered to Seller by registered mail addressed to Seller at the address hereinafter set forth, or at such other address as Seller may hereafter designate in writing, to-wit: 1111 United States National Bank Building, Portland, Oregon.

Any and all notices which Seller may be required or may have the option of giving to Buyer shall be delivered to it by registered mail addressed to Buyer at 612 South Flower Street, Suite 840, Los Angeles 17, California, or at such other address as Buyer may from time to time designate in writing.

XXII.

This agreement shall be binding upon and insure to the benefit of the respective heirs, executors, administrators, successors and assigns of the parties hereto.

253 In Witness Whereof, Seller has hereunto affixed his hand and seal, and Buyer has caused its corporate name and seal to be hereunto affixed by its duly authorized officers, on the date in this agreement first hereinabove written.

CALIFORNIA INSTITUTE FOR CANCER RESEARCH

Attest:

/s/ H. B. LIBBY,
Assistant Secretary

By /s/ GEORGE CASTERA,
President
Buyer

/s/ CLAY BROWN
Clay Brown (6,000 shares)
acting for himself and all of the other stockholders of Clay Brown & Co. namely:

/s/ DOROTHY E. BROWN
By CLAY BROWN
Dorothy E. Brown (6,000 shares)
By Clay Brown, Attorney-in-fact

/s/ DONALD BROWN
By CLAY BROWN
Donald Brown (6,000 shares)
By Clay Brown, Attorney-in-fact

/s/ PHILIP BROWN
By CLAY BROWN
Philip Brown (6,000 shares)
By Clay Brown, Guardian

/s/ MARILYN BROWN
By CLAY BROWN
Marilyn Brown (6,000 shares)
By Clay Brown, Guardian

/s/ C. H. HILL
By CLAY BROWN
C. A. Hill (500 shares)
By Clay Brown, Attorney-in-fact

/s/ NANCY H. BOOTH
By CLAY BROWN
Nancy H. Booth (500 shares)
By Clay Brown, Attorney-in-fact

[s] C. W. BOOTH
By CLAY BROWN
C. W. Booth (1,000 shares)
By Clay Brown, Attorney-in-fact
Seller

254 POWER OF ATTORNEY

Know All Men by These Presents: That we, Dorothy E. Brown, Nancy H. Booth, and C. W. Booth, owners of capital stock of Clay Brown & Company, an Oregon corporation, have made, constituted, and appointed, and

by these presents do make, constitute, and appoint Clay Brown of the United States National Bank Building, Portland, Oregon, our true and lawful attorney to represent us, and each of us, and in our name, place and stead and for our use and benefit to sell and transfer unto the California Institute for Cancer Research the shares of stock of Clay Brown & Company, indicated opposite the undersigned names, we, and each of us, now own, for the same price and upon the same terms and conditions as Clay Brown sells his stock in Clay Brown & Company. Giving and granting unto our said attorney, full power and authority to do and perform all and every act and thing whatsoever requisite and necessary to be done to accomplish and complete said sale including but not limited to execution, as our representative and in our behalf, and for each of us, all purchase agreements and any and all documents and instruments and any modifications or amendments of the offer made to the California Institute for Cancer Research, dated January 24, 1953, to sell all of the outstanding stock of Clay Brown & Company, as Clay Brown shall deem proper and advisable.

Witness Our Hands at Portland, Oregon this 28th day of January, 1953.

/s/ Dorothy E. Brown Dorothy E. Brown	6,000 shares
/s/ Nancy H. Booth Nancy H. Booth	500 shares
/s/ C. W. Booth C. W. Booth	1,000 shares

255 POWER OF ATTORNEY

Know All Men by These Presents: That I, Don Brown, am owner of capital stock of Clay Brown & Company, an Oregon corporation, have made, constituted, and appointed, and by these presents do make, constitute, and appoint Clay Brown of the United States National Bank Building, Portland, Oregon, my true and lawful attorney to represent me, and in my name, place and stead and for my use and benefit to sell and transfer unto the California Institute for Cancer Research the Six Thousand (6,000) shares of capital stock of Clay Brown & Company I now

own, for the same price and upon the same terms and conditions as Clay Brown sells his stock in Clay Brown & Company. Giving and granting unto my said representative and attorney full power and authority to do and perform all and every act and thing whatsoever requisite and necessary to be done to accomplish and complete said sale, including but not limited to execution as my representative and in my behalf of all purchase agreements and any and all documents and instruments and any modification or mandments of the offer made to the California Institute for Cancer Research, dated January 24, 1953, to sell all the outstanding stock of Clay Brown & Company, as Clay Brown shall deem proper and advisable.

Witness my hand at Fortuna, California this 30th day of January, 1953.

/s/ Don Brown

256 POWER OF ATTORNEY

Know All Men by These Presents: That I, C. A. Hill, am owner of capital stock of Clay Brown & Company, an Oregon corporation, have made, constituted, and appointed, and by these presents do make, constitute, and appoint Clay Brown of the United States National Bank Building, Portland, Oregon, my true and lawful attorney to represent me, and in my name, place and stead and for my use and benefit to sell and transfer unto the California Institute for Cancer Research for Five Hundred (500) shares of capital stock of Clay Brown & Company I now own, for the same price and upon the same terms and conditions as Clay Brown sells his stock in Clay Brown & Company. Giving and granting unto my said representative and attorney full power and authority to do and perform all and every act and thing whatsoever requisite and necessary to be done to accomplish and complete said sale, including but not limited to execution as my representative and in my behalf of all purchase agreements and any and all documents and instruments and any modification or amendments of the offer made to the California Institute for Cancer Research, dated January 24, 1953, to sell all the outstanding stock of Clay

Brown & Company, as Clay Brown shall deem proper and advisable.

Witness my hand at Fortuna, California this 30th day of January, 1953.

/s/ C. A. Hill

257 LETTERS OF GUARDIANSHIP

DEPARTMENT OF PROBATE

No. 69438

State of Oregon,
County of Multnomah, ss:

I, Si Cohn, County Clerk and Ex-Officio Clerk of the Circuit Court of the State of Oregon, in and for the County of Multnomah, do hereby certify that on the 29 day of January, A.D. of 1953 Clay Brown was appointed Guardian of the estates of Philip Frank Brown and Marilyn Claire Brown, minors infants and minors of said County and State, and said Clay Brown having given the bond required by law, is therefore, In the Name of the State of Oregon, duly authorized to take upon himself the guardianship of the estates of said minors and is hereby fully empowered to perform all acts which are or hereafter may be required of him according to law.

In Testimony Whereof, I, Si Cohn, County Clerk and Ex-Officio Clerk of the Circuit Court, have hereunto subscribed my name and affixed the seal of said Court, this 29th day of January, A.D. 1953.

Si Cohn, County Clerk and Ex-Officio Clerk of the Circuit Court,
By Harry N. Nelson, Deputy.

(SEAL)

CERTIFICATE

State of Oregon,
County of Multnomah, ss:

I, Si Cohn, County Clerk, Ex-Officio Recorder of Conveyances and Ex-Officio Clerk of the Circuit Court of the State of Oregon, for the County of Multnomah, which Court has exclusive jurisdiction of all probate proceedings in said County, do hereby certify that the foregoing copy of

Letters of Guardianship has been compared by me with the original, and that it is a correct transcript therefrom, and the whole of such original, as the same appears of record in my office and in my custody.

I further certify that said Letters are now in full force and effect.

In Testimony Whereof, I have hereunto set my hand and affixed the seal of said Court, this 29 day of January, A.D. 1953.

Si Cohn, County Clerk,
By R. E. Sonderen
Deputy

This Court Requires That:

An Inventory and appraisement must be filed within thirty days.

A report showing condition of ward and ward's estate annually.

A final report when ward becomes of age or at expiration of trust.

258 **Exhibit 44-RR**

PROMISSORY NOTE

Dated Feb. 4, 1953

$1,300,000.00

California Institute for Cancer Research, a California nonprofit corporation (hereinafter referred to as the "Institute") for value received hereby promises to pay to Clay Brown, Dorothy E. Brown, Donald Brown, Philip Brown, Marilyn Brown, C. A. Hill, Nancy H. Booth and C. W. Booth the principal sum of One Million Three Hundred Thousand ($1,300,000.00) Dollars, without interest, payable as hereinafter provided:

This note is non-negotiable and evidences the purchase price for the stock of Clay Brown & Company, an Oregon corporation, and notes of Clay Brown and Dorothy E. Brown being purchased by the Institute under a purchase agreement dated February 4, 1953, which purchase agreement is herein incorporated by reference.

The Institute shall pay the $1,300,000.00 evidenced by this note in the manner and at the times provided in said purchase agreement, a summary of which provisions are as follows: $5,000.00 forthwith after the liquidation of Clay Brown & Company, and the balance out of ninety per cent of all royalties or rents received in cash by the Institute under the lease and license agreement dated February 4, 1953 between the Institute and Fortuna Sawmills, Inc. or under any substitute lease agreement with any other lessee covering the assets received by the Institute upon the liquidation of Clay Brown & Company. Such payment shall be made by the Institute within five days after receipt by the Institute of each payment of such royalties or rental. The Institute may prepay any or all of the amount remaining unpaid hereon at any time. The entire balance of this promissory note shall in any event become due and payable on the 31st day of January, 1963. The promisee shall have the right, at his option to accelerate the entire unpaid balance in the event that the Institute breaches any provisions of said
259 purchase agreement or in the event that the Institute shall fail to pay to the promisee hereon a total of $250,000.00 during any two consecutive lease years during the life of the lease referred to in said purchase agreement. The foregoing does not purport to be a complete summary of the provisions of said purchase agreement relating to payments, and payments shall be made under this note in accordance with all applicable provisions of said purchase agreement, whether or not summarized above and not otherwise. Payments made by the Institute to the promisee shall be allocated as provided in said purchase agreement.

After this note becomes due, either on the maturity date of January 31, 1963 or upon acceleration as above provided, any unpaid balance then remaining shall bear interest at the rate of five per cent per annum.

This note is secured by a deed of trust and a chattel mortgage bearing even date herewith.

In Witness Whereof, the California Institute for Cancer Research has caused this note to be duly executed

and its corporate seal to be hereunto affixed at Los Angeles, California, this 4th day of February, 1953.

CALIFORNIA INSTITUTE FOR CANCER RESEARCH

By George Castera,
President

By H. B. Libby,
Ass't. Secretary

(Corporate Seal)

260 **Exhibit 47-UU**

GENERAL ASSIGNMENT FROM CALIFORNIA INSTITUTE FOR CANCER RESEARCH TO CLAY, BROWN, ET AL.

Whereas, California Institute for Cancer Research (hereinafter called the "assignor"), has purchased, all of the outstanding capital stock of Clay Brown & Company, an Oregon corporation, from the stockholders, Clay Brown, Dorothy E. Brown, Donald Brown, Philip Brown, Marilyn Brown, C. A. Hill, Nancy H. Booth and C. W. Booth (hereinafter called the "assignees"), and two promissory notes in the sum of $125,000.00 from Clay Brown and Dorothy E. Brown; and

Whereas, the assignor has dissolved Clay Brown & Company and as security for payment of the unpaid balance of the purchase price for the stock of Clay Brown & Company and the promissory notes, the assignor simultaneously herewith is giving to the assignees a deed of trust and chattel mortgage covering certain assets of Clay Brown & Company received by the assignor upon the dissolution of said corporation; and

Whereas, the parties desire that the assignor shall make certain assignments to the assignees as additional security for the unpaid balance of the purchase price of the stock of Clay Brown & Company and of the promissory notes.

Now, Therefore, as security for the full and faithful performance by the assignor of all the terms and provisions

of the purchase agreement between the assignor and assignees dated February 4, 1953 and as security for payment by the assignor of the sum evidenced by a promissory note from the assignor to the assignees given pursuant to said purchase agreement, the assignor does hereby assign, transfer and convey to the assignees, their heirs, successors and assigns, all of the assignor's right, title and interest in and to:

261 1. The lease and license agreement dated February 4, 1953 between the assignor as lessor and Fortuna Sawmills, Inc. as lessee.

2. The contracts, agreements, leases and subleases listed in Exhibits "C" and "D" to the above mentioned lease and license agreement dated February 4, 1953.

3. The promissory note executed or to be executed by Fortuna Sawmills, Inc. pursuant to Paragraph V (c) of said purchase agreement dated February 4, 1953.

Provided, However, That this assignment shall in no way affect the right of the assignor to keep and retain for its own benefit and purposes ten per cent of all rental and royalties received by it under the above mentioned lease and license agreement with Fortuna Sawmills, Inc. free from the requirement of payment upon the unpaid balance of the purchase price for the stock of Clay Brown & Company and the promissory notes purchased by the assignor from the assignees as long as the assignor shall have such right under said purchase agreement and is not in default thereunder.

This assignment is given for the sole purpose of assuring and securing to the assignees, their heirs, successors and assigns, the full, complete and faithful performance of said purchase agreement and all other agreements incident thereto and said assignees, and each of them, and their respective heirs, successors and assigns in their own names or in the name of the assignor as they shall elect, shall have the right to enforce the agreements and contracts herein assigned, and each of them, and any or all provisions thereof, by legal proceedings or otherwise.

Provided in all events, however, that when said purchase agreement has been fully performed and the pur-
262 chase price for the stock of Clay Brown & Company and the promissory notes has been fully paid by the assignor, this agreement shall be of no further force or effect.

In Witness Whereof, California Institute for Cancer Research, pursuant to a resolution of its Board of Directors duly and legally adopted, has caused these presents to be signed by its authorized officers and its seal to be hereunto affixed this 4th day of February, 1953.

CALIFORNIA INSTITUTE FOR CANCER RESEARCH

By /s/ GEORGE CASTERA,
President

By /s/ H. B. LIBBY,
Asst. Secretary

263 **Exhibit 49-WW**

LEASE AND LICENSE AGREEMENT

This Lease and License Agreement, made and entered into this 4th day of February, 1953, by and between California Institute For Cancer Research, an no-profit corporation organized and existing under and by virtue of the laws of the State of California, hereinafter referred to as Lessor, and Fortuna Sawmills, Inc., a California corporation, hereinafter referred to as Lessee;

WITNESSETH:

That, for and inconsideration of the mutual covenants and agreements herein contained, and other good and valuable consideration, Lessor hereby leases and licenses to Lessee, and Lessee hereby leases and licenses from from Lessor:

(a) The real property, together with improvements thereon as listed and set forth on Exhibit "A" attached hereto and by this reference made a part hereof;

(b) The personal property listed and set forth on Exhibit "B" attached hereto and by this reference made a part hereof;

(c) The good will of Clay Brown & Company;

(d) The patents, patent applications, trademarks and inventions, timber and logging contracts, listed and set forth on Exhibit "C" attached hereto and by this reference made a part hereof;

(e) Subleases as listed and set forth on Exhibit "D" attached hereto and by this reference made a part hereof. All of the property covered by, and which is the subject of this lease is hereinafter, for convenience, referred to as the "demised premises."

To Have and To Hold for a term of five (5) years, commencing on the 1st day of February, 1953, and continuing for a period of five (5) years thereafter, to and including the 31st day of January, 1958.

It Is Mutually Understood and Agreed that this lease and license agreement is made upon the following covenants, conditions, provisions and agreements:

(1) That, during the term of this lease, Lessee covenants to pay as rental and royalty to Lessor for said
264 demised premises an amount each year equal to eighty (80%) per cent of the net profits resulting from the use and occupancy of the demised premises.

(2) The words "net profits" where used in this lease shall be construed to mean net profits before depreciation, income, franchise, excess profits or other similar federal or state taxes computed in accordance with good accounting practice by public accountants mutually acceptable to the parties hereto, and Lessee may deduct from gross income in the computation of net profits all expenses incident to the operation of said demised premises and of said business, including reasonable salaries to officers, partners, executives and employees, and including also all specific charges which Lessee agrees to assume under this lease (other than rental payable hereunder as provided in paragraph (1) above) and all expenses incident to the determination of the proper rental to be paid in accordance with the terms of this lease and in the construction or interpretation of the terms hereof.

(3) Lessee shall compute the net profits for each semi-annual period during the term of this lease, beginning

with the three month period ending on the last day of April, 1953, and each six (6) month period thereafter. On or before the thirtieth (30) day following the close of each semi-annual period, Lessee shall pay to Lessor the rental and royalties so computed for the preceding semi-annual accounting period (or shorter first and last period of three months) in accordance with the provisions hereof.

(4) If the operations of Lessee shall have resulted in a loss during any prior semi-annual period or periods then such net profits for any subsequent semi-annual period may first be applied by the Lessee toward the recovery of any such loss before any further semi-annual rental payments shall become due the Lessor hereunder.

(5) Lessor shall have the right at its option to cancel and terminate this lease on a thirty day written notice, in event that the Lessee shall not have paid to Lessor a total sum of $277,778.00 as rental and royalties during any two consecutive full annual accounting periods. For the sole purpose of calculating the amounts paid by the Lessee to the Lessor in rentals and royalties during any two consecutive calendar years, there shall be added to the cash amounts so paid, the aggregate amounts expended or incurred for capital improvements or additions in said two consecutive calendar years.

265 Lessee shall use and exert its best efforts at all times to cause said demised premises to be productive of the highest possible net profits consistent with good business judgment and sound and economical operations but the rentals hereunder shall accrue only in event that net profits are earned through the operation of the demised premises and the business to be conducted by Lessee upon or in connection therewith. Lessee shall operate and conduct the business herein contemplated continuously (on normal work days and during normal working hours) during the term of this lease, but failure so to conduct said business by reason of strikes, acts of providence, or other causes beyond the control of Lessee shall not be deemed a default by Lessee in the requirements hereof. Lessee alone shall bear any and all losses suffered or incurred by it in the operation of the business herein contemplated.

(7) Lessor shall not be called upon at any time or in any manner to pay or cause to be expended any sums for the maintenance or repairs of said demised premises or personal property, provided that nothing herein contained shall be construed as preventing Lessee from deducting such costs consistently with the provisions of the next following paragraph in computing rental due hereunder.

(8) Lessee shall maintain said demised premises in a good state of repair, ordinary wear and tear, fire and other unavoidable casualty alone being excepted. Lessee may, at its discretion, alter, add to, or improve, or repair the demised premises with the mutual understanding that the costs and expenses of such alterations, additions, improvements, or repairs, if subject to capitalization as required by the Federal Income Tax Regulations, shall be capitalized and the amount thereof credited upon the next installment or installments of rental due to Lessor; provided, however, that Lessee shall not expend or incur expenses for any such capital improvements or additions during any full annual accounting period described in paragraph (3) hereof in excess of the sum of Twenty-five Thousand ($25,000.00) Dollars without the written consent of Lessor. In event that any such alterations, additions or improvements or repairs shall not be subject to capitalization as required by the Federal Income Tax Regulations, then the costs thereof shall be charged as an expense in the operation of Lessee's business. Any and all such alterations, additions, and improvements or repairs made in and to the demised premises shall be and remain the property of Lessor, and Lessee shall
266 execute and deliver to the Lessor all such documents as may be necessary to convey title to the same to Lessor. Automotive equipment and other expendable personal property shall be replaced by Lessee at Lessee's cost and expense, and the title thereto shall vest in Lessor.

(9) Lessee shall pay in cash the rental under the subleases listed in Exhibit "D" attached hereto. Said rental shall be charged by the Lessee as a normal business expense prior to the determination of net profits upon which the rental and royalties to the Lessor are to be calculated.

(10) Lessee shall pay before delinquent all general property taxes levied or assessed against said demised premises; and shall keep all of said demised premises at all times from and after the time of the commencement of the terms of this lease, free and clear of all mechanics' liens or other liens of like nature not existing upon the commencement of said term. Lessee shall post and keep posted in prominent places on the demised premises notices of non-responsibility of Lessor for work, labor and materials furnished to Lessee.

(11) Lessor or its agents, at all times during reasonable business hours, shall have the right of access to the demised premises for the purposes of inspection of the premises and books thereof.

(12) Lessee shall, at its expense, insure the demised premises, and as well, the operations conducted thereon or in connection therewith, against such risks as may be mutually agreed upon by the parties hereto. Lessee agrees to furnish to Lessor a list and description of all types of insurance in force on the first day of July of each and every calendar year during the term of this lease or any extension thereof, and the failure on the part of Lessor to notify Lessee of its dissatisfaction with the adequacy of such insurance coverage shall demonstrate the concurrence of Lessor in the adequacy thereof.

(13) In event of damage to or destruction of said demised premises by fire or other insured cause, the proceeds of insurance policies covering such rish shall be used to restore and rebuild said premises to the mutual satisfaction of the parties hereto, subject, however, to the terms and conditions of any mortgage upon said premises.

(14) This lease shall not be assigned by Lessee either directly or indirectly, nor by operation of law without the express written approval of Lessor, and the consent by Lessor to one or more such assignments shall not be deemed or considered a waiver of the requirement
267 that Lessor consent in writing to any further or subsequent assignments nor be deemed the consent of Lessor to any such further or subsequent assignments: Neither said demised premises nor any of the

personal property which is the subject of this lease shall be sublet by Lessee without first obtaining the written consent of Lessor. During the continuance of this lease a majority of all of the issued and outstanding capital stock, together with the full and complete voting right appurtenant thereto of Lessee, must be held only by such persons as are approved in writing by Lessor, and unless Lessor shall have approved in writing the persons holding a majority of the issued and outstanding stock of Lessee, together with the full and complete voting rights appurtenant thereto, then and in such event, Lessor may, at its election, cancel and terminate this lease by giving to Lessee a written notice of such default and upon the failure of Lessee completely to cure said default within a period of thirty (30) days from the time of giving of said written notice this lease shall forthwith terminate.

(15) In event of any default of Lessee under the provisions of this lease, other than a default in the payment of rental, or default in payment of obligations and liabilities assumed concurrently herewith by Lessee in connection with the purchase of current assets by Lessee from Lessor, or in event of any violation by Lessee of any of the terms or conditions of this lease, Lessor shall serve notice, on Lessee of such default or violation. If, within thirty (30) days after receipt of such notice, Lessee fails to commence and thereafter diligently to proceed to cure such default or violation, then, in addition to such other remedies as may be provided by law, Lessor shall have the option and right to declare this lease cancelled and terminated and to reenter said demised premises or any part thereof, and to take possession of all or any part of said demised premises either with or without process of law; and thereafter, all of the rights of Lessee hereunder shall terminate and Lessee shall execute any and all documents or instruments necessary to reconvey to Lessor any and all property or rights acquired by Lessee hereunder. In event that Lessee shall fail to pay any installment or rental or royalty when due and said default shall continue for a period of thirty (30) days after the end of any full annual accounting period, and said default is not cured within said thirty day period without

notice from Lessor, then Lessor shall have the option to forthwith cancel and terminate this lease.

(16) Lessee agrees that in the use of the patents, patent applications, trademarks, and inventions, that it will
268 use its best efforts to improve said patents and inventions, and to develop additional inventions in connection with the operation of said business. Lessee agrees that any such improvements, developments or additional inventions, whether or not used in connection with said business, shall be and at all times remain the property of the Lessor, and Lessee agrees to notify and advise Lessor promptly in writing of any such improvements, developments, or additional inventions so that Lessor may apply for patents and protection thereon, and Lessee agrees to and does hereby indemnify, save and hold harmless Lessor from the claim or claims of any employee, officer, agent, or representative of Lessee who might claim the ownership or any right, title or interest in any such improvement, developments or new inventions.

(17) Lessor is the owner of the name and good will of Clay Brown & Company and Lessee is hereby given the right to use said name or any derivative or variation thereof, including Lessee's name, in the conduct of the business contemplated by this lease during the continuance of this lease or any extension or renewal thereof; provided, however, that upon the final expiration or sooner termination of this lease, then all of said names shall revert to and remain the property of Lessor, and Lessee shall not thereafter be entitled to use said name or names in the conduct of any business competitive with the business to be conducted by Lessee as provided for in this lease, and Lessee shall cause its corporate name to be changed so as to comply with the provisions of this paragraph.

(18) In event that any dispute shall arise between the parties to this lease as to any matter relating hereto or contained herein, or as to the performance of the terms or conditions hereof, such dispute shall be settled by arbitration in the following manner:

Lessor shall appoint an arbiter and shall notify Lessee in writing of the name and address of the person so appointed; Lessee shall, within five days thereafter, ap-

point an arbiter and shall notify Lessor in writing of the name and address of the person so appointed. The two arbiters thus appointed shall choose a third, and in the event that they fail to do so within ten days of the date of the appointment of Lessee's arbiter, such third arbiter shall be a person designated by the presiding judge of the Superior Court of Los Angeles County. The three persons so designated shall proceed, in accordance with the rules of the American Arbitration Association, to
269 determine such dispute and shall render their decision therein, and such decision so rendered shall be binding upon both parties to this lease.

(19) Concurrently herewith Lessor has executed, as Buyer, a Purchase Agreement of even date, and this Lease and License Agreement is being assigned by the Lessor under the said Purchase Agreement as security for all of the obligations and liabilities of the Lessor, as Buyer under said Purchase Agreement. In the event of the default by the Lessor as Buyer under said Purchase Agreement, and thereafter the Sellers under said Purchase Agreement become the owners of this Lease and License Agreement, then and in said event the said Sellers shall have the right and privilege at their option to cancel and terminate this lease at any time upon a ten (10) day notice in writing directed to the Lessee.

(20) Until the principal note described in the Purchase Agreement has been paid in full, this Lease and License Agreement may not be amended, changed or modified by the parties hereto without first obtaining the written approval thereof from Clay Brown.

(21) The Leseee agrees to enter into an agreement with Clay Brown wherein and whereby Clay Brown shall be employed as general manager of the Lessee until the expiration or sooner termination of this lease, and if for any reason Clay Brown is unable to unwilling to so act, the person or persons holding a majority interest in the principal note described in the Purchase Agreement shall have the right to approve his successor to act as general manager of Lessee company.

(22) Upon the expiration or sooner termination of this lease, Lessee shall, at the option of Lessor, assign to Lessor

any and all contracts or orders that are assignable and that remain executory at said time.

(23) All notices herein provided shall be addressed and delivered to Lessor at 612 South Flower Street, Suite 840, Los Angeles 17, California, or at such other address as Lessor may from time to time designate in writing.

(24) All notices herein provided for shall be addressed or delivered to Lessee at 1001 Board of Trade Building, Portland, Oregon, or at such other place or places as Lessee may from time to time designate in writing.

IN WITNESS WHEREOF, Lessor and Lessee have caused their corporate names and seals to be affixed by
270 their duly authorized officers, respectively, the date in this Lease and License Agreement first above written.

CALIFORNIA INSTITUTE FOR CANCER RESEARCH

By (signed) GEORGE CASTERA
President
Lessor

ATTEST:

(signed) H. B. LIBBY
Assistant Secretary

SEAL

FORTUNA SAWMILLS, INC.
By (Signed) CALVIN N. SOUTHER
President
Lessee

ATTEST:

(signed) WILLIAM H. KINSEY
Secretary

SEAL

271 State of California
County of Los Angeles, ss:

On this 3rd day of February, 1953, before me appeared George Castera and H. B. Libby, both to me personally known who being duly sworn, did say that he, the said George Castera is the President and he, the said H. B. Libby is the Assistant Secretary of California Institute

for Cancer Research, and that the seal affixed to said instrument is the corporate seal of said corporation, and that the said instrument was signed and sealed in behalf of said corporation by authority of its Board of Directors, and said George Castera and H. B. Libby acknowledged said instrument to be the free act and deed of said corporation.

In testimony whereof, I have hereunto set my hand and affixed my official seal, this the day and year first in this, my certificate, written.

MARGUERITE LUMBER
Notary Public for Los Angeles County

My Commission Expires: Feb. 22, 1955

(Seal)

State of Oregon
County of Multnomah, ss:

On this 4th day of February, 1953, before me appeared Calvin N. Souther and William H. Kinsey, both to me personally known who being duly sworn, did say that he, the said Calvin N. Souther is the President and he, the said William H. Kinsey is the Secretary of Fortuna Sawmills, Inc., and that the seal affixed to said instrument is the corporate seal of said corporation, and that the said instrument was signed and sealed in behalf of said corporation by authority of its Board of Directors, and said Calvin N. Souther and William H. Kinsey acknowledged said instrument to be the free act and deed of said corporation.

In testimony whereof, I have hereunto set my hand and affixed my official seal, this the day and year first in this, my certificate, written.

JOHN R. SABIN
Notary Public for Oregon

My Commission Expires: Oct. 26, 1956

(Seal)

272 EXHIBIT "A"

LAND:

That real property located in the County of Humboldt, State of California bounded and described as follows:

Beginning at the southwest corner of the southeast quarter of the southwest quarter of Section 2, in Township 2 North Range 1 West, Humboldt Meridian;

and running thence east on the section line 23 chains, more or less, to the west line of the strip of land used and occupied by the Northwestern Pacific Railroad Company;

thence northwesterly along the west line of said strip of land 20.75 chains, more or less to the north line of the southeast quarter of southwest quarter of said section;

thence west along the subdivision line to the northwest corner of said subdivision;

and thence south on the west line of the same 20 chains to the point of beginning and containing approximately 39.23 acres.

That parcel in the northeast quarter of the southwest quarter of Section 2 of Township 2 North, Range 1 West, Humboldt Meridian, described as follows:

Beginning at a point on the south line of said subdivision located south 89 degrees 32 minutes west 196.09 feet from the southeast corner of said subdivision, said point of beginning being in the center line of the Northwestern Pacific Railroad right-of-way; running thence from said point of beginning along said south line of said sub-division, south 89 degrees 32 minutes west 106.29 feet to an iron pipe monument designated "B" on survey by Richard B. Stipovich for Clay Brown & Co., Inc., completed September 27, 1949; thence continuing along said south line 89 degrees 32 minutes west 613.98 feet; thence north 28 minutes west 210 feet; thence north 89 degrees 32 minutes east 655.67 feet to the center line of said right-of-way; thence along said center line south 17 degrees 34 minutes east 219.71 feet to the point of beginning, and containing 3.15 acres, not including the area of the aforementioned right-of-way.

BUILDINGS

Sawmill "A"
Mill "A" Sorting Shed
Sawmill "B"
Mill "B" Sorting Shed.
Planing Mill
Office
Miscellaneous Buildings:
Shop
Carrier Garage
Saw Shed
273 Drag Saw Shed
Toilet #1
Toilet #2
Oil House
Power Service Shed
Tool Shed
Store House
Log Scaler Shed
Log Unloader Shed
Pump House #1
Pump House #2
Pump House #3
Fire Pump House
Hose House #1
Hose House #2
Hose House #3
Hose House #4
Hose House #5

274 EXHIBIT "B"

MACHINERY AND EQUIPMENT:

All machinery and equipment in Sawmill "A" constituting a Swedish gan mill complete including:

Log haul per Mill Engineering & Supply catalog No. 502
Log kicker
Log guide per catalog No. 181
Infeed carriage per catalog No. 171
36" super gang saw per Mill Engineering & Supply Company catalog No. 143

Roller case behind gang saw per catalog No. 190
Transfer chain to edger
Transfer skids
Shadow line guide.

All of above manufactured by Mill Engineering & Supply Company of Seattle, Washington.

1½ ton chain hoist
Portland Iron Works 6" by 48" Style E LH and stub edger
24" thirteen-saw gang trimmer manufactured by Peters Co., Portland, Oregon
5¾ x 4¾ x 5 Gardner-Denver Model WBQ vertical two-stage water-cooled six cylinder air compressor complete including motor and 30" x 7' air receiver
Yates-American LH vertical 60" resaw
Rolls
Transfers
Conveyors
4 power panels, and

All necessary related items such as:

Motors
Switches
Pipe and fittings
Fire apparatus
Saws and tools, and in addition

Filing room equipment including:

Armstrong No. 7-I filing machine
No. 22 Armstrong automatic gan saw sharpener
No. 7 Armstrong gan saw filing clamp
No. 4 Armstrong saw stretcher roll
Cast iron leveling block
No. 6 Armstrong swage
No. 3 Armstrong shaper and
All related motors, switches, chains and conveyors.

• • • • •

All machinery and equipment in Mill "A" Sorting Shed including:

Rolls and transfers
Motors
Chain
Pipe and fittings
Fire apparatus
Tools, and
Miscellaneous equipment

276 All machinery and equipment in Sawmill "B" constituting a complete band mill including:

Log haul
Log dock
Transfers
Log stop and loader
3 arm Simondson pattern log turner
Canting gear
9' Star-Cunningham RB ban mill No. 3
Carriage
Carriage drive

All of above except Star-Cunningham band mill and log haul manufactured by Peters Co., Portland, Oregon.

8" x 54" six-saw edger manufactured by Portland Iron Works, Portland, Oregon

Eleven-saw trimmer manufactured by Peters Co., Portland, Oregon

Gardner-Denver 7½ x 5¾ x 5 compressor Model No. WBH-4012 with 24" x 6" air receiver complete

Two power panels
Saw sharpener
Roller and stitcher
Saw hoist
Welder
Rollers and transfers
Conveyors
Pipe and fittings
Fire apparatus
Tools and miscellaneous equipment and all related motors

• • • • •

All machinery and equipment in Mill "B" Sorting Shed including:

Chain
Transfers
Motors
Pipe and fittings
Fire apparatus

277 All machinery and equipment in Planing Mill constituting a complete planing mill and sorting shed including:

Yates-American A-66 6" x 15" planer/matcher, manufacturer's Serial No. B-657
Spray treating equipment
Electric Swede pull-off manufactured by Keystone Machine Works, Roseburg, Oregon
No. 36 Irvington cut-off saw manufactured by Irvington Machine Works, Portland, Oregon
Power panel

Head and knife grinders including Hanchett 32" grinder
Chain and related motors and including:

Rolls and transfers
Pipe and fittings
Saws
Heads and knives
Tools and miscellaneous equipment

70" steel plate single ballbearing exhaustor manufactured by Central Blowpipe Manufacturing Company, Escalon, California and related motors and equipment.

* * * * *

All machinery and equipment in Shop including:

Excelsior 21" drill press manufactured by Rogersford Foundry & Machine Company, Rogersford, Pennsylvania
300 amp. General Electric portable horizontal arc welder
8" stroke No. 6156 Miller Knuth motorized power hack saw
Stanley 6" double end cylinder
18" swing 7' bed Bradford lathe manufactured by Bradford Machine & Tool Company, Cincinnati, Ohio

Model 110 Malsbury Steam Cleaner, and
Related motors
Pipe and fittings
Tools and miscellaneous equipment.

All machinery and equipment in Carrier Garage including:

Ross Series 90 Straddle lumber carrier Type 90-7956 manufacturer's Serial No. 2023 Engine No. 195138

Tools and miscellaneous equipment, but
Excluding:

1 Hyster Lift Truck RT-150 Serial No. 50676 Motor No. 248798
1 Hyster Straddle Truck Model M3-5766 Serial No. 63528 Motor No. 295871
278 1 Osgood Mobile Crane Model 715, Serial No. 5383 Caterpillar Motor D13000 Serial No. 1F8528
1 Hyster Space Saver Lift Truck Model RT-150 Serial No. 56146 Motor No. 295573
1 Hyster Straddle Truck M3-5766 Serial No. 55694 Motor No. 24020

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No. 60 shaving and edging Burner manufactured by Central California Blowpipe Company, Inc., Escalon, California, complete with:

Spark screen
Pipe ladder and
Steel cat-walk

• • • • •

50′ air-cooled shaving and edging Burner manufactured by Eureka Boiler Works, Eureka, California, complete with:

Screen
Ladder, and
Cat-walk

• • • • •

One DeWalt Cut-Off Saw and Guard housed in Saw Shed

• • • • •

All machinery and equipment in and related to Drag Saw Shed including:

Model DKS Serial No. 116-T 9' Blue Babe chain saw
Miscellaneous wiring, switches, motor, tools and equipment.

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All tools and miscellaneous equipment in toilets, oil house, tool shed, store house, log scale shed, log unloader shed, pump houses, fire pump houses and hose houses, including:

Fire pumps
Sump pumps
Power panels
Fire apparatus
Log unloading winch and motor
Rigging, and other related items, tools, and equipment.

279 All wiring, switches, motors, circuit breakers and related equipment in Power Service Shed.

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All equipment and machinery in Yard:

Power service
Conveyors
Motors
Dust cooling system
Blowers
Pipe and fittings
Tanks
Boom and clam shell for use with Model 715 Osgood Mobile Crane but excluding said crane
Model D-4 Caterpillar Tractor Serial No. 7-U-771 equipped with Traxcavator No. 3569 blade, and
Hyster D-4 winch No. BW-6777
11 x 13 Wilamette Humboldt three-drun yarder complete with controls, motor, rigging and related equipment
A portable Chrysler engined Byron Jackson pump Engine No. C-36-6120
Model No. 36 Fakhiem electrically operated price and gallonage-indicating gasoline pump
3 fully equipped water wells with pumps

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All furniture, fixtures and equipment in Office Building including:

2—60" x 32" oak typewriter desks
3—60" x 34" oak double pedestal desks
1—60" x 36" and
1—69" x 38" walnut-mahogany executive desks
1—60" x 34" double pedestal oak desk with linoleum top
1—72" x 34" oak table
6—oak side chairs
4—oak swivel arm chairs
2—Shepard steel upholstered posture chairs
3—Shaw-Walker four drawer steel letter files
1—Red leather upholstered davenport
1—Matching chair
3—Walnut-mahogany side chairs
1—Sturgis autographic register
1—ten-inch Royal typewriter Serial No. KMM-3685320
280 1—fourteen-inch Royal typewriter Serial No. KMM 14-R2632280
1—Friden eight-column electric calculator Serial No. S8-101189
1—ten-key Remington Rand electric adding machine Serial No. 93-797385
1—ten-key Victor electric adding machine Serial No. 5716660
1—nine-column Burroughs hand calculator Serial No. 5-974363
1—Model 74 seven-column Todd Check Protector Serial No. N747-R4418
1—Detex watchman's clock with ten stations
1—Johnson floor polisher

Miscellaneous items including:

Chair pads
Waste baskets
Desk trays
Miscellaneous desk accessories
Rubber mats
Clocks
Cleaning equipment, etc.

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TRUCKS AND AUTOMOBILES

1—1948 White dump truck—Serial No. 244012 Engine No. 120A16153
1—1949 Chevrolet pick-up—Engine No. GBA-548945
1—1951 Chevrolet pick-up—Engine No. JBA-1197406
1—1953 Plymouth Cranbrook Savoy—Engine No. P2447791
1—1951 Chevrolet 2-door Sedan—Engine No. JAA-1232922
1—1953 Chrysler 4-door Sedan—Motor No. C-53-8-15860

281 EXHIBIT "C"

Timber purchase and sales agreement dated October 31, 1950 between Clay Brown & Company and Henry J. and Edith F. Vicenus.

Log sale and purchase agreement entered into September 15, 1952 between William E. Layman and Clay Brown & Company including a supplement dated September 30, 1952 correcting expiration date of the contract to read January 1, 1954.

Agreement dated August 1, 1952 between Robert K. Olson and Clay Brown & Company covering sale by Olson and purchase by Clay Brown & Company of logs, said agreement to expire May 1, 1953.

Agreement dated January 31, 1950 between Northwestern Pacific Railroad Company and Clay Brown & Company concerning operation and maintenance of spur railroad track on Clay Brown & Company properties near Rohnerville, Humboldt County, Califiornia.

Contract of October 27, 1949 between Clay Brown & Company and Pacific Gas & Electric Company covering installation and maintenance of electric service.

Contract dated January 15, 1951 between Clay Brown & Company and Pacific Gas & Electric Company covering installation and maintenance of electrical service.

Contract dated November 30, 1949 and expiring February 28, 1954 between Standard Oil Company of California and Clay Brown & Company relating to sale by Standard Oil Company to Clay Brown & Company of Chevron gasoline.

282 EXHIBIT "D"

LEASE:

Field warehouse lease of August 25, 1952 between Lawrence Warehouse Company and Clay Brown & Company comprising certain real property and pond area on Clay Brown & Company millsite, Fortuna, California.

Field warehouse lease dated September 22, 1952 between Lawrence Warehouse Company and Clay Brown & Company covering areas designated as Units B and C for the purpose of warehousing logs on Clay Brown & Company millsite, Fortuna, California.

Lease agreement dated October 31, 1952 and expiring October 31, 1953; entered into between Brown Timber & Investment Company and Clay Brown & Company covering rental and use of Hyster Model M-3-5766 Straddle Truck.

Lease agreement dated June 16, 1952 and expiring June 16, 1953; entered into between Brown Timber & Investment Company and Clay Brown & Company covering rental and use of Hyster Model RT 150 Lift Truck.

Lease agreement dated June 15, 1952 and expiring June 15, 1953; entered into between Brown Timber & Investment Company and Clay Brown & Company covering rental and use of Hyster Model M-3-5766 Straddle Truck.

Lease agreement dated March 30, 1952 and expiring March 31, 1953; entered into between Brown Timber & Investment Company and Clay Brown & Company covering rental and use of Model 715 Osgood Mobile Crane.

Lease dated December 7, 1951 and expiring December 31, 1954 between The United States National Bank of Portland, Oregon and Clay Brown & Company covering office premises in Rooms 1109, 1110 and 1111 U. S. National Bank Building.

Exhibit 50-XX

283

GENERAL ASSIGNMENT TO FORTUNA SAWMILLS, INC.

KNOW ALL MEN BY THESE PRESENTS, That CALIFORNIA INSTITUTE FOR CANCER RESEARCH, a California non-profit corporation (hereinafter called the "Assignor"), for and in consideration of the sum of Ten ($10.00) Dollars and other valuable consideration in hand paid by FORTUNA SAWMILLS, INC., a California corporation (hereinafter called the "Assignee"), the receipt of which is hereby acknowledged, does hereby sell, assign and transfer to the Assignee, its successors and assigns, all of the Assignor's right, title and interest in and to all cash (in excess of Five Thousand ($5,000.00) Dollars which sum is hereby retained), bank accounts, inventory (including lumber inventory, log inventory and any other inventory) accounts receivable, notes, trade acceptance, chose in action, and any and all other assets, tangible or intangible which the Assignor received or is entitled to receive as sole stockholder upon the liquidation of Clay Brown & Company, an Oregon corporation, *save and except*, only such assets (other that the beforementioned $5,000.00) received by the Assignor upon the liquidation of Clay Brown & Company which are leased and licensed to Fortuna Sawmills, Inc. under the lease and license agreement dated February 4, 1953, by and between the Assignor as lessor and the Assignee as lessee executed by the parties contemporaneously herewith, *provided*, however, that the assignment of the assets herein is subject to all of the liabilities and obligations of Clay Brown & Company assumed by the Assignor or which accrued to the Assignor upon or by virtue of the liquidation of Clay Brown & Company and the receipt by the Assignor of all the assets of Clay Brown & Com-

284 pany upon such liquidation, except two promissory notes owed by Clay Brown & Company to Clay and Dorothy E. Brown in the aggregate principal amount of $125,000.00, all of which liabilities, except for said notes, the Assignee assumes and agrees to pay; and

The Assignor hereby authorizes the Assignee in the Assignor's name to sue, give releases, take any legal steps and do all things the Assignee may deem necessary or ap-

propriate in carrying out the intention of this general assignment which is to grant to the Assignee, subject to the liabilities as aforesaid, all of the assets (except for the beforementioned $5,000.00), tangible and intangible, of Clay Brown & Company received by the Assignor upon the liquidation of Clay Brown & Company, other than the assets leased by the Assignor to the Assignee under the beforementioned lease.

IN WITNESS WHEREOF, CALIFORNIA INSTITUTE FOR CANCER RESEARCH pursuant to a resolution of its Board of Directors duly and legally adopted has caused these presents to be signed by its authorized officers and its seal to be hereunto affixed this 4th day of February, 1953.

CALIFORNIA INSTITUTE FOR CANCER RESEARCH

By GEORGE CASTERA
President

By H. B. LIBBY
Ass't. Secretary

(Corporate Seal)

285 STATE OF CALIFORNIA }
COUNTY OF LOS ANGELES } ss.

On this 28 day of February, 1953, before me, a notary public in and for said County and State, resident therein, duly commissioned and sworn, personally appeared George Castera known to me to be the president of the corporation that executed the within instrument, and personally appeared H. B. Libby known to me to be the Ass't. Secretary of the corporation that executed the within instrument, and both of such persons acknowledged to me that such corporation executed the same.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

ALTA B. HERRICK
Notary Public in and for said County and State

My Commission Expires 12/6/54

(SEAL)

Exhibit 51-YY

Dated Feb. 4, 1953

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ASSUMPTION AGREEMENT OF FORTUNA SAWMILLS, INC.

WHEREAS, FORTUNA SAWMILLS, INC., a California corporation, hereinafter called "Fortuna", received by general assignment from CALIFORNIA INSTITUTE FOR CANCER RESEARCH, hereinafter called "California Institute", all the assets, tangible and intangible received by California Institute upon the liquidation of Clay Brown & Company, other than certain assets leased by Fortuna from California Institute under a lease and license agreement; and

WHEREAS, California Institute executed said general assignment to Fortuna pursuant to paragraph V (c) of the purchase agreement dated February 4, 1953 between Clay Brown and certain other stockholders of Clay Brown & Company, an Oregon corporation, and California Institute, which paragraph provides that Fortuna shall agree in writing to assume to pay out of the assets so assigned, all of the liabilities of Clay Brown & Company except certain notes to stockholders, and to pay California Institute as therein provided a sum equal to the excess of such assets over the assumed liabilities.

NOW, THEREFORE, FORTUNA hereby assumes and agrees to pay when due, out of and only out of the assets received by Fortuna under the general assignment from California Institute, all of the current and deferred expenses, obligations and liabilities of Clay Brown & Company as shown on the audit of the books of Clay Brown & Company to be prepared by its accountants, Peat, Marwick, Mitchell & Co. of Portland, Oregon, as of the close of business on January 31, 1953, excepting the notes owed by Clay Brown & Company to Clay Brown and Dorothy E. Brown in the aggregate sum of $125,000.00.

287 Fortuna further agrees to pay to California Institute out of the assets so received under said general assignment a sum equal to the amount by which the total assets so received as shown on the beforementioned audit

as of January 31, 1953 exceeds the total liabilities and obligations assumed hereunder as shown on said audit, which excess shall be evidenced by and paid in accordance with a promissory note due and payable on or before five years from the date hereof, without interest, but with an acceleration clause in the event Fortuna defaults in the payment of any of said liabilities herein assumed by Fortuna. In determining the beforementioned excess of assets over liabilities, such assets and liabilities shall be computed at the book value thereof as disclosed by said audit as of January 31, 1953.

It is understood that if it shall become necessary for Fortuna to obtain independent financing and credit, and in order to do so it shall be required to obtain the subordination of said note to said financing or credit then California Institute agrees to so subordinate said note.

IN WITNESS WHEREOF, FORTUNA SAWMILLS, INC. has caused this assumption agreement to be duly executed in its name and on its behalf by its officers duly authorized thereunto by the Board of Directors.

FORTUNA SAWMILLS, INC.

By CALVIN N. SOUTHER
By WILLIAM H. KINSEY

(SEAL)

288 STATE OF OREGON }
COUNTY OF MULTNOMAH } ss.

On this 4th day of February, 1953, before me, a notary public in and for said County and State, resident therein, duly commissioned and sworn, personally appeared Calvin N. Souther known to me to be the president of the corporation that executed the within assumption agreement, and personally appeared William H. Kinsey, known to me to be the secretary of the corporation that executed the within assumption agreement, and both of such persons acknowledged to me that such corporation executed the same.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

JOHN R. SABIN
Notary Public in and for said County and State

(SEAL) My Commission Expires Oct. 26, 1956

Exhibit 52-ZZ

289 PROMISSORY NOTE

$20,991.79 May 15, 1953

FORTUNA SAWMILLS, INC., a California corporation (hereinafter referred to as "Fortuna"), for value received hereby promises to pay to CALIFORNIA INSTITUTE FOR CANCER RESEARCH (hereinafter referred to as the "Institute"), on or before February 4, 1958 the principal sum of Twenty Thousand, Nine Hundred Ninety-one and 79/100 (20,991.79) Dollars without interest.

This note is given pursuant to an Assumption Agreement of Fortuna Sawmills, Inc. executed on February 4, 1953 as required by paragraph V(c) of a Purchase Agreement dated February 4, 1953 between Clay Brown and certain other stockholders of Clay Brown & Company.

In the event Fortuna defaults in the payment of any of the liabilities assumed by Fortuna under the beforementioned Assumption Agreement, the full amount due under this note shall become immediately due and payable upon such default at the option of the Institute.

The beforementioned paragraph V(c) of the Purchase Agreement provides that in the event it shall become necessary for Fortuna to obtain independent financing or credit, and in order to do so, it shall be required to obtain the subordination of this note to said financing or credit, then the Institute agrees to so subordinate this note. In accordance with such provision this note is hereby subordinated to any and all sums owed by Fortuna to The United States National Bank of Portland, Oregon, whether or not secured by a mortgage or warehouse receipts. This note may from time to time be subordinate to other indebted-

nesses of Fortuna in accordance with the beforementioned provision of paragraph V(c) of the Purchase Agreement.

IN WITNESS WHEREOF, FORTUNA SAWMILLS, INC. has caused this note to be duly executed in its name and on its behalf by its duly authorized officers.

FORTUNA SAWMILLS, INC.

By CALVIN N. SOUTHER
Calvin N. Souther,
President

By WILLIAM H. KINSEY,
William H. Kinsey,
Secretary

(Corporate Seal)

Exhibit 53-AAA

290 EMPLOYMENT AGREEMENT

AGREEMENT made and entered into as of the 4th day of February, 1953 by and between FORTUNA SAWMILLS, INC., a California corporation (hereinafter referred to as the "company") and CLAY BROWN.

1. The company hereby employes Brown as general manager of the company for the term of five years from February 1, 1953 to and including January 31, 1958. It is intended that the employment of Brown shall continue during the period of the lease dated February 4, 1953 between the company as lessee and California Institute for Cancer Research as lessor, and if said lease shall for any reason terminate or be terminated prior to the expiration date specified in said lease, then the employment of Brown hereunder shall likewise terminate upon the termination of said lease.

2. Subject to the supervisory control of the board of directors of the company, Brown's duties as general manager shall include supervision and management of the following: operation of the company's facilities at Fortuna, California; the manufacture and sale of the company's products; performance by the company of the lease and license agreement dated February 4, 1953 between the company as

lessee and California Institute for Cancer Research, as lessor; employment and fixing of the compensation of employees; and any and all other duties usually incident to those of a general manager of a business of the type of that carried on by the company, including such other duties as the board of directors may from time to time prescribe. During the term of this agreement Brown shall devote his best efforts and such portion of his time as shall be necessary to carry out his duties hereunder, and Brown shall not, directly or indirectly, engage in any activity or business which competes with the business carried on by the company.

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3. The Company shall pay to Brown a salary of Twenty-five Thousand ($25,000.00) Dollars per year as his entire compensation for services to the company during the term of this agreement. Such salary shall be paid in equal monthly installments.

4. This agreement shall inure to the benefit of, and shall be binding upon the company, its successors and assigns.

IN WITNESS WHEREOF the parties have executed this agreement as of the date first above mentioned.

FORTUNA SAWMILLS, INC.
By CALVIN N. SOUTHER

CLAY BROWN
Clay Brown

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SPECIAL MEETING OF BOARD OF DIRECTORS of FORTUNA SAWMILLS, INC.

A special meeting of the board of directors of Fortuna Sawmills, Inc. was held at 2 o'clock p.m. on October 26, 1954, at the 10th Floor of the Board of Trade Building, Portland, Oregon.

Present were Calvin N. Souther, William H. Kinsey and Raymond P. Underwood constituting all of the directors of the corporation. Mr. Souther acted as chairman of the meeting and Mr. Kinsey acted as secretary.

The chairman presented to the meeting the letter received from Clay Brown announcing his resignation as general manager of the corporation. Upon motion duly made and seconded the following resolutions were unanimously adopted:

RESOLVED, that the resignation of Clay Brown as general manager of the corporation be and hereby is accepted and the employment agreement dated February 4, 1953 between this corporation and Clay Brown be and the same hereby is terminated effective October 31, 1954; and

RESOLVED FURTHER, that Clay Brown shall be retained by the corporation in an advisory capacity and the corporation shall pay him a salary of $1,000.00 per month for such services; and

RESOLVED FURTHER that no successor to Mr. Brown as general manager will be appointed at this time, it having been determined by the board of directors that the present personnel of the corporation, particularly Mr. C. W. Booth in the Portland office and Mr. C. A. Hill at the sawmill, are capable of carrying on the business of the corporation with the advisory services to be extended by Mr. Brown.

There being no further business the meeting was adjourned.

WILLIAM H. KINSEY
William H. Kinsey,
Secretary

293 SPECIAL MEETING OF THE
BOARD OF DIRECTORS
of
FORTUNA SAWMILLS, INC.

A special meeting of the board of directors of Fortuna Sawmills, Inc., was held at 10 A.M. on November 8, 1954, at 1001 Board of Trade Building, Portland, Oregon.

Present were Calvin N. Souther, William H. Kinsey and Raymond P. Underwood, constituting all of the directors of the corporation. Mr. Souther acted as chairman of the meeting and Mr. Kinsey acted as secretary.

On motion duly made and seconded the banking resolution of The United States National Bank of Portland (Ore-

gon) in the form attached to the minutes of this meeting was unanimously adopted.

There being no further business the meeting was adjourned.

WILLIAM H. KINSEY
William H. Kinsey,
Secretary

The undersigned directors hereby approve the foregoing minutes of Fortuna Sawmills, Inc. and hereby waive any and all notice required for the holding of said meeting.

CALVIN N. SOUTHER
Calvin N. Souther

WILLIAM H. KINSEY
William H. Kinsey

RAYMOND P. UNDERWOOD
Raymond P. Underwood

294 BE IT RESOLVED, that The United States National
295 Bank of Portland (Oregon), at any one or more of its offices, be and it hereby is designated as the banking depository of this corporation, and that checks on the company's account shall be signed by any *one* of the following, individually.

Clay Brown, General Manager, or
C. W. Booth, Controller, or
Agnes N. Koch, Bookkeeper

or by any *two* of the following:

Calvin N. Souther, President
William H. Kinsey, Secretary-Treasurer
C. A. Hill, Resident Mill Manager
Don Brown, Assistant Resident Manager
Henry A. Vogel
Claire McCloskey

STATE OF OREGON
COUNTY OF MULTNOMAH } ss.

I, William H. Kinsey, hereby certify that I am the duly elected, qualified and acting secretary of FORTUNA SAWMILLS, INC., a California corporation, and as such in pos-

session of the record book of the corporation containing the records of the meetings of the stockholders and directors thereof; that the within and foregoing is a full, true and complete copy of a resolution duly adopted by the directors of said corporation, at a duly called and held meeting, held on the 8th day of November, 1954, at which a quorum was present and voted in favor of said resolution. I further certify that the officers named in the foregoing resolution have been duly elected and have qualified to the offices designated in said resolution.

IN WITNESS WHEREOF, I have hereunto set my official signature and the seal of said corporation this 8th day of November, 1954.

.....
Secretary.

(Corporate Seal)

Exhibit 55-CCC

296 MINUTES OF SPECIAL MEETING OF THE BOARD OF DIRECTORS OF THE CALIFORNIA INSTITUTE FOR CANCER RESEARCH

A special meeting of the Board of Directors was called to order by the Chairman at 4:30 P.M., Pacific Standard Time at the California Club, 538 South Flower Street, Los Angeles, California, on Tuesday, January 27, 1953, pursuant to written notice thereof duly given January 22, 1953.

Directors present at the meeting when called to order by the Chairman were:

Judge Stanley N. Barnes
Mrs. William Barnhart
Mr. George Castera
Mr. M. Philip Davis
Mr. A. J. Lorenz
Mr. Robert Robinson
Mr. L. H. Seagrave
Dr. Stafford L. Warren
Dr. Vern O. Knudsen
Mr. Kendall Thurston
Dr. Elmer Belt (came in at 5:00 P.M.)

Directors absent from the meeting were:

Mrs. John Buwalda
Mr. K. O. Baker
Mr. John Canaday
Dr. Sidney C. Madden
Mr. Lewis A. Weiss
Judge Frederick F. Houser
Dr. Harry B. Priedgood

Also present was Mrs. Harriet Libby, assistant secretary of the Institute.

The Chairman asked the President, Mr. Castera to preside at the special meeting inasmuch as the matter to be discussed was one in which he had a personal financial interest which had been disclosed to the members of the Industrial Investment Committee.

The President took the chair, announced that a quorum was present and thereafter presided at the meeting.

The President announced that the first thing to be taken up was the proposed deal with Clay Brown & Co. which Mr. Seagrave had submitted to the Industrial Investment Committee, and which the committee had spent considerable time going over. The President then asked Mr. Seagrave if he would review it again inasmuch as some of the directors present had not previously been acquainted with the deal.

297 Mr. Seagrave then reviewed the proposed purchase of Clay Brown & Company of Portland and Eureka, and submitted various papers which are attached to the minutes of this meeting. He disclosed that his interest was a 2% commission, to be paid by the sellers when, as and if payments on the purchase are made.

There ensued a thorough discussion of the contracts to be signed and Mr. Castera stated that the Industrial Investment Committee had voted to accept this proposition.

It was decided that the letter of proposal of Clay Brown & Co. would be eliminated and that the purchase contract and the lease and license agreement would be revised.

Upon motion by Dr. Warren, seconded by Mr. Thurston, and unanimously approved by the directors present (Mr. Seagrave abstaining from voting), the following resolution was adopted:

RESOLVED, That a legal Committee is hereby appointed to consist of Mr. M. Philip Davis, Judge Stanley M. Barnes and Judge Frederick F. Houser to go over the two agreements and make any revisions they felt to be to the best interests of the Institute, and to pass and approve other documents in connection with the proposed purchase.

Upon motion duly made, seconded and unanimously carried (Mr. Seagrave abstaining from voting), the following resolutions were adopted:

RESOLVED, That the president and secretary or assistant secretary of this corporation be and they are hereby authorized and instructed to execute for and on behalf of this corporation the Purchase Agreement by and between Clay Brown, Dorothy E. Brown, Don Brown, Philip Brown, Marilyn Brown, C. A. Hill, Nancy H. Booth, and C. W. Booth, as Sellers; and this corporation, as Buyer, in substantially the same form as outlined in the draft of the Purchase Agreement submitted and approved subject to such changes in terms and/or conditions and/or provisions as the said officers may, in their discretion and with approval of counsel chairman of legal committee, deem to be for the best interests of this corporation; and

BE IT FURTHER RESOLVED, That the president and the secretary or assistant secretary of this corporation be and they are hereby authorized and instructed to execute for and on behalf of this corporation the Lease and License Agreement by and between this corporation as Lessor, and Fortuna Sawmills, Inc. as Lessee, in substantially the same form as outlined in the draft of the Lease and License Agreement submitted and approved subject to such changes in terms and/or conditions and/or provisions as the said officers may, in their discretion and with approval of counsel chairman of legal committee, deem to be for the best interests of this Corporation; and

298 BE IT FURTHER RESOLVED, That the president and the secretary or assistant secretary be and they are further authorized and instructed to execute for and on behalf of this corporation any and all other documents and instruments that may be necessary, required or convenient for the final consummation of all the transactions contem-

plated by said Purchase Agreement and by said Lease and License Agreement.

There being no further business to come before the Board at this time, the meeting was adjourned.

[Illegible]
Secretary

L. H. SEAGRAVE
Chairman of the Board

GEORGE CASTERA
President

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REVISED PROFORMA, SUBSTITUTING APPRAISED VALUATION, BALANCE SHEET

CLAY BROWN & COMPANY

December 31, 1952

ASSETS

Current Assets:		
Cash	$ 17,211	
Accounts and Notes Receivable	127,491	
Inventories—at market	519,807	
Prepaid expenses	11,548	
		$ 676,057
Other Assets:		
Plant, property and equipment at appraised value (Fortuna)	$ 836,759	
Land, 42.38 acres at $1,500	63,570	
Circular saw, omitted from appraisal	1,500	
Supplies	25,000	
Furniture & equipment, Portland & San Francisco	10,376	
Increase in automobiles	2,000	
Timber, less depletion	123,000	
		1,062,205
Deposits and Deferred Charges		2,166
		$ 1,740,428

LIABILITIES

Current Indebtedness:		
Demand notes payable to U. S. Nat'l Bank secured by log inventory	$ 301,392	
Current accounts payable	71,270	
Provision for federal income and Oregon excise taxes	135,000	
Timber contract payable	32,563	
Portion of mortgage debt payable within one yr.	38,916	
		$ 579,141
Long-term debt:		
3-year mortgage note payable, balance to U.S. Nat'l Bk.	$ 104,047	
Less payments due within one year	38,916	
		65,131
Capital Stock and Notes (to be sold):		
Demand Notes to stockholders	$ 125,000	
Common stock, 32,000 shares	32,000	
Capital surplus	13,986	
Earned surplus	466,389	
Surplus from appraisal	458,781	1,096,156
		$ 1,740,428

300 Committee on Industrial Investment
California Institute for Cancer Research
Mr. George Castera, Chairman

Dear Sirs:

Subsequent to the meeting of your committee on Saturday, January 24, 1953, I talked on Sunday at some length with Mr. Clay Brown at Portland, Oregon.

He arranged to send me the Appraisal Survey of the General Appraisal Company, bringing the previous appraisal up to date.

He advised me that the new lessee California corporation to be known as Fortuna Sawmills, Inc., would have initial paid in capital of $25,000, but that it had an authorized capital of $50,000, and that an additional $25,000 would be paid in, if found necessary.

He also stated that he was a signer personally on the mortgage, and that he would also be a personal signer on the new mortgage to the U. S. National Bank, which would be for approximately $101,000, to which it had now been paid down. He hopes to arrange this mortgage on a five year basis, which would make the annual service of it about $23,000, and have the effect of increasing the net current

assets by $80,000. If the bank does not make that arrangement, he feels sure that the bank will make it a three-year loan, on which the annual service would be about $38,000, as it has been.

Mr. Brown advises that he has been assured by the U. S. National Bank that it will continue to lend on logs and lumber, as in the past, with a line up to $400,000.

Mr. Brown read me a memo detailing the working funds they could rely on, which I have reduced to a memorandum, attached hereto. He says that he is in a position to provide funds, or to lend his personal credit to insure adequate funds. He thinks the working capital position will not be as much of a problem as it has been in the past.

There are enclosed the following:

Analysis of the increase in asset value, which shows that the increase has in reality, been only about 20% more in the appraisal than at cost.

A revised, corrected pro-forma balance sheet of Clay Brown & Co.

A pro-forma opening statement of Fortuna Sawmills, Inc. with an estimated revision for April 30th, reflecting the probable position, after reduction of log inventory, payments on taxes, earnings. I believe the opening statement is correct, except for a deduction from cash of $5,000, the down payment to be made prior to the sale of the net asset position.

L. H. SEAGRAVE

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FORTUNA SAWMILLS, INC.

Pro Forma

	At Closing		Estimated At April 30, 1953	
ASSETS				
Cash, taken over	$ 17,211		$ 62,211	
Cash, paid in	25,000			
Accounts & Notes receivable	127,491		127,491	
Inventories—at market	519,807		119,807	
Prepaid expenses	11,548		11,548	
		$701,057		$321,057
Deposits and deferred charges		2,166		2,166
		$703,223		$323,223
LIABILITIES				
Demand notes payable to U.S. Nat'l Bank	$301,392		$ 1,392	
Current accounts payable	71,270		51,270	
Provision for federal income and Oregon excise taxes	135,000		65,000	
Timber contract payable	32,563		32,563	
Portion of mortgage note payable within one year	38,748		38,748	
		$578,973		$188,973
Mortgage note payable, U.S. Nat'l Bk.	$104,047			
Less payments due within one year	38,748			
		65,299		65,299
Note To California Institute (Subordinated to bank loan)		33,951		33,951
Capital stock outstanding & earned surplus		25,000		45,000
		$703,223		$323,223

Net working capital at Jan. 31, 1953:

Current Assets	$701,057
Current Liabilities	578,973
	$122,084

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FORTUNA SAWMILLS, INC.

PROJECTION OF AVAILABLE WORKING FUNDS

	Funds	Assuming that U. S. Nat'l Bk. makes note payable serially in 3 yrs. current funds would be increased as follows:
At Feb. 1, 1953		
Net current assets received	$ 28,000	$ 96,000
New capital	25,000	25,000
Subordination of note to Institute	33,000	33,000
	$ 86,000	$154,000
Reserve for taxes	135,000	135,000
Available funds	$221,000	$289,000
Estimated earings Feb. & Mar.	100,000	100,000
At April 1, 1953	$321,000	$389,000
Taxes due April 15th	64,000	64,000
Balance	$257,000	$325,000
Payment of rent June 1	80,000	80,000
Balance	$177,000	$245,000
Taxes due July 15	54,000	54,000
Balance	$123,000	$191,000
Earnings estimated April, May, June	90,000	90,000
Balance	$213,000	$281,000
Taxes due Oct. 15	18,000	18,000
Balance	$195,000	$263,000
Earnings estimated to Oct. 1	90,000	90,000
Balance	$285,000	$353,000
Payment of rent Dec. 1	144,000	144,000
Balance	$141,000	$209,000
Earnings estimated No., Dec., Jan.	50,000	50,000
Balance at Jan. 31, 1954	$191,000	$259,000

The above projection does not include two sources of working funds, if needed, i.e. $25,000 additional capital and loans of $50,000 from Clay Brown.

CLAY BROWN & CO.

	10/31/52	Appraisal Survey 11/31/52	1/20/53	Increase
Property, Plant & Equipment, at cost:				
Building	$173,520	$173,520		
Equipment and facilities	405,301	406,203		
Automotive, yard and logging equipment	26,992	26,992		
Furniture & Fixtures, Fortuna	7,751	7,751		
Furniture & Fixtures, Portland	7,375	7,375		
Automobiles	13,014	13,014		
	$633,953	$634,855	$ 836,759	$201,904(1)
Land (42.38 acres) (Current market $1,500 per acre)	24,635	24,635	63,570	38,935
Supplies, (Previously expenses. C. W. Booth believes will inventory at at more than $30,000)			25,000	25,000
Circular saw mounting (omitted from inventory at price offered for it)			1,500	1,500
Timber, less depreciation (Scaled at 15,000,000 feet at market of $8.20 per M)	50,927	47,722	123,000	75,278
Additional investment in automobiles			2,000	2,000
Furniture & Fixtures, San Francisco & Portland (previously expenses)			10,376	10,376
	$709,515	$707,212	$1,062,205	$354,993

(1) This increase of 31.8% in appraisal over cost includes many items previously expenses, but picked up and appraised, aggregating $63,063 at cost.

The actual increase in appraisal of property appraised on cost is—

Book value of cost	$634,855
Assets expenses	63,063
Total Cost	$697,918
Appraisal	836,759
Increase	$138,841 or about 20%

This increase is consistent with advance in market for this class of equipment.

MISCELLANEOUS DATA

1. Company began sawmill operation May 1, 1950.

2. Net before taxes:

Year ended April 30, 1951		$415,533
Year ended April 30, 1952		145,078
	(nearly $70,000 expenses)	
Six months to Oct. 31, 1952		207,567
		$768,000
Average annual earnings before taxes		$307,270
Capital items expensed during 2½ years:		
Supplies & tools on hand	$25,000	
Other items	33,000	
Labor and const. lumber	40,000	
	$98,000	
Average annual		32,500
Total average annual earnings		$339,000

3. Sales in 2½ year period aggregated 91,454,177 board feet. An average per annum of about 30,000,000 board feet.

4. Sales per thousand have averaged as follows:

1950	$64.48
1951	57.85
1952	63.21

5. The company has sales offices in Portland, Oregon. It owns two mills, on 44 acres, near Fortuna, Calif., about 16 miles south of Eureka.

6. Until December, 1952 operated one with a Swedish gang saw, and a 54" circular saw, which latter has been replaced by a 9 ft. band saw, which has been in operation since Jan. 1st.

7. November and December sales were off seasonally, but the first four months of this year are seasonally good, and Clay Brown expects to cut about 15,000,000 ft. in remainder of the company's fiscal year, at an estimated profit

of $150,000 before taxes. This will bring profit, if realized, to $357,500 for the year.

305 8. The two mills are well planned, and sturdily built. They get their logs both by rail, dumped into their large pond, and by truck, also unloaded at pond edge.

9. Most of the property has a gravel surfacing, with black-top on the roads and on areas where trucks travel from grading shed to yard.

10. Clay Brown cuts only fir—no redwood, since redwood requires large investment due to long air drying period and necessary stocking. There is as much fir in Humboldt County as redwood.

11. Company is represented in Los Angeles by the A. L. Hoover Co., La Brea & Wilshire. They have four salesmen. A. L. Hoover, father; Richard Hoover, son; Robert Hoover, son; Mr. Lieschman in office; and Mr. Boyeer, outside.

12. There are relatively few fir mills in this area of Northern California, and the freight advantage in Southern California is about $6 per M., over Portland, and $2.50 per annum to San Francisco area. This company also enjoys a bulk carload rate, which is an advantage over pound rate from Oregon and Washington.

13. He sells now—70% in So. California; 20% in Bay area; 10% to Texas points. He is aiming at 100% sales in Southern California.

14. He could show a gross of about $250,000 on a cut of 50,000,000 ft. even if he made no profit, but merely sold at same price as competitors and made the freight differential.

15. Earnings of an average of $360,000 would pay out purchase price in five years.

16. Assets as appraised by General Appraisal Co., July 1951, with adjustments for items capitalized, expensed or not included in appraisal, result in net worth of $1,136,156. Six percent interest on deferred balances, assuming an

average of $360,000 earnings per annum, would total $237,112.

Total Worth	$1,136,156
Interest	237,112
	$1,373,268

17. Clay Brown has a good reputation in Portland, Oregon, and generally throughout the lumber and plywood industry. Mr. Carvel Linden of the U. S. National Bank, Portland, stated to me January 14, 1953; "Clay Brown is a top operator. His situation is clean. I have advised him, solely because of his tax burden, to sell to you if he could come to terms with you. We think that his achievement in starting this lumber company, and producing and selling profitably the first month, and 26,400,000 ft. the first year at a net profit before taxes of $415,553, is a real achievement."

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306 CLAY BROWN & Co.

Directors & Officers

Mr. Clay Brown, President & Director
Mr. Clarence Hill, Vice President-resident manager & director
Mr. Don L. Brown, Ass't vice president-Ass't manager & director
Mr. C. W. Booth, Secretary-treasurer & director
Mrs. Dorothy E. Brown, Director

Mr. Clay Brown—President

Director—West Coast Lumbermens Ass'n
Director—Clay Island Inc.
Formerly director—U. S. Plywood & Subsidiaries 1943-1945
Formerly vice president—U. S. Plywood & Subsidiaries
President and director of Tekwood (subsidiary of U. S. Plywood)
Long Bell Lumber Co.—1926-1932 (various capacities)
M & M Company, Portland—Sales Manager—1932-36

Vice President of Ralph L. Smith Lumber Co. 1036-43
(Missouri Corp.) In charge of West Coast operation
Humboldt Plywood Co.—president & director
Sold in 1948
President and general manager to Sept. 1948
Company sold for $1,250,000
Clay Brown Co. in wholesale lumber business to 1950

Mr. Clarence Hill—Vice president and resident manager

Various capacities in Squimm, Washington
Long Bell Lumber Co.—various capacities
Miles Lumber Co.—vice president & director
Wholesale lumber business in Kansas City
Humboldt Plywood Co.—1945—vice president
Clay Brown & Co.—1950

Mr. C. W. Booth—Secretary-Treasurer

Commercial Credit Corp.—1936
Humboldt Plywood Co.—Treasurer
Merchant Marine—1943-45
1948—secretary-treasurer of this company

Mr. Don L. Brown—Assistant vice president & Ass't manager

Oregon State College
Since 1949—with Clay Brown & Co.

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307 ASSETS

Appraisement survey of Clay Brown & Company, bringing appraisal up to December 31, 1952, by General Appraisal Company.

Appraisement	$ 836,759
Circular Saw	1,500
Supplies on hand	25,000
Land—42.38 acres @ $1,500	63,570
Timber, less depletion	123,000
Furniture & Fixtures—Portland & San Francisco	10,376
Auto	2,000
	$1,062,205

November 3, 1954

Mr. Clay Brown,
U. S. National Bank Building,
Portland 4, Oregon.

Re: *California Institute for Cancer Research*

Dear Mr. Brown:

In our review of current tax developments we have kept in mind the lease and license agreement dated February 4, 1953 between the California Institute and Fortuna Sawmills, Inc., together with the agreement dated February 4, 1953, between the California Institute as buyer, and you, acting for yourself and for the other stockholders of Clay Brown & Co., as seller. A recent ruling published by the Bureau of Internal Revenue should be of particular interest to you. A copy of this ruling is attached (Rev. Rul. 54-420, 1 R.B. 1954-39, 5 C.C.H. Paragraph 6432—9/29/54).

You will note that the ruling outlines, without mentioning names, an arrangement identical in all major respects to your sale of Clay Brown & Co., stock to the Institute and the lease agreement between the Institute and Fortuna Sawmills, Inc.

The portion of the ruling relating to the exempt status of the charitable institution is not particularly pertinent since there is little doubt that the Institute is otherwise exempt under Sec. 101 (6) of the code and the Instiute is not subject to Sec. 3814 of the code which denies exemption to certain organizations under certain circumstances. However, the portions of the ruling which we have underlined are significant to your situation. Considering first the last sentence of the ruling, it is the position of the Bureau that in an arrangement such as the one existing between you, the Institute, and Fortuna Sawmills, Inc., the amounts received by the selling stockholders from the charitable institution will not be recognized as proceeds from a sale requiring capital gains treatment. If the Bureau is able to substantiate such a contention, the gain realized by you upon the sale of the stock of Clay Brown & Co. would be taxed as ordinary income rather than as capital

gain. We doubt that the Bureau will be able to substantiate such a contention, especially if your management contract with Fortuna Sawmills, Inc., is eliminated. However, it is advisable to avoid a controversy with the Bureau if
309 possible, and we believe the suggestions hereafter made in regard to revision of the lease will help in this respect.

Perhaps the mose significant portion of the ruling from your viewpoint is the last sentence of the second from the last paragraph which relates that payments labeled as rent in the lease arrangement will not be recognized as rent for purposes of the exemption in Sec. 422 (a) of the code if such payments are in reality a return of profits by a person or corporation operating the property for the benefit of the tax-exempt organization, or if such payments are a share of the profits retained by the tax-exempt organization as a partner or a joint venture. The inference is that the payment of 80% of net profits will not be recognized by the Bureau as rent in spite of the designation of such payments as rent in the lease agreement. If the payments do not qualify as rent, then the 80% of the net profits received by the California Institute will be taxed to it. We understand that taxation of the rental payments to the Institute would force the Institute to default in its payments to you for the stock of Clay Brown & Co.

If the 80% of the net profits payable by Fortuna Sawmills, Inc., to the Institute under the lease is a fair rental for the use of the leased property, then we believe that the Bureau will have a difficult time in substantiating the contention that such payments are not rental and therefore should be taxed to the Institute. As you may recall, when the proposal of the Institution was first submitted to you we prepared an eleven-page memorandum giving our opinion in regard to the tax consequences of the arrangement. The first paragraph of our summary in the memo on pages 10 and 11 reads as follows:

> "SUMMARY: In summary of the foregoing, we are of the opinion that there is a possibility the 80 per cent of the profits to be paid by the new corporation to the Institute in the form of rental might be taxed to the Institute. Therefore, if the deal is premised upon such rental payments being exempt when received by the

Institute, we would advise that a ruling be obtained from the Treasury Department. Also, some provisions should be made as to what would happen if the law should change in the future so as to subject such rental payments to taxation if they are exempt under the present law."

We discussed the possibility of obtaining a ruling from the Treasury Department with Mr. Paul R. Coté, counsel for the Institute. He informed us that he had determined from his dealings with the Bureau that they would not give rulings on the arrangement, but that it was his understanding the Bureau would not upset or question such arrangements.

310 A change of the Bureau's attitude seems to be indicated by the ruling. Not only has the Bureau made a formal ruling, but its conclusions are adverse to the tax consequences desired by you and the Institute.

It would seem from the ruling that there must be a considerable number of other such arrangements which follow a definite pattern identical to your arrangement with the Institute. It seems to be a standard provision that the operating company will pay as rental and royalty an aggregate of 80% of the net profit of the operating company before taxes. We understand that such arrangements cover a variety of other businesses in addition to sawmills. A serious doubt would seem to exist as to whether 80% of net profits can constitute a fair rental in all instances. As before stated, we believe the success of the Bureau's attempt not to recognize the payments as rental for purposes of Sec. 422 (a) depends to a large extent upon the fairness of the rental. While 80% of the net profit may be a fair rental for Fortuna Sawmills, Inc., it may be difficult to convince the Bureau of this in view of the numerous other instances in which a similar contention will be made in regard to other assets. If it is not logical to suppose that 80% of the net profits is a reasonable rental in all of the similar arrangements, then you can expect a rather cold reception from the Bureau when you contend that the payment of 80% of the net profit by Fortuna Sawmills, Inc., is a fair rental.

We believe your position can be materially strengthened if the lease and license agreement is amended in such manner as to provide for a rental which is not the same as that followed in the other similar arrangements. The easiest rental to substantiate wouud be a flat amount per month, but this is obviously impracticable. The next best thing is to base the rental upon the quantity of lumber manufactured by Fortuna Sawmills, Inc. We asked you what you as an experienced lumberman, would be willing to pay per thousand feet of lumber manufactured for use of sawmill facilities similar to those of Fortuna. You answered that $5.00 per thousand should be a very fair rental. Mr. Booth has projected the amount of the rental based upon $5.00 per thousand as compared to the rental accrued under the present terms of the lease. This is set forth on the attached schedule. It shows that the rental based on $5.00 per thousand would be substantially more for the short fiscal year ended April 30, 1953 and for the full fiscal year ended April 30, 1954. The rental at $5.00 per thousand for the first five months of the current fiscal year is less than the rent accrued under the present formula. An estimate of busines for the balance of the fiscal year shows that the rent at $5.00 per thousand will be a little more than under the present formula, giving a total rental for the current fiscal year at $5.00 per thousand which is $61,905.02 less than the rental generated under the present formula ($338,579.24 under the present formula minus $276,674.22 at $5.00 per thousand). The $61,905.02 deficiency is substantially less than the excess of the rental at $5.00 per thousand for the previous years which could be carried over to the current fiscal year.

The last line of the enclosed schedule shows that the rental for the period February 1, 1953 to April 30, 1955, would be $558,762.17 at $5.00 per thousand as compared to $383,021.61 under the present formula. This gives an excess of rental at $5.00 per thousand over rental under the present formula of $175,740.56 which could be carried over to the remaining fiscal years under the lease. If the future years are as good and no better than the anticipated current fiscal year, the before-mentioned carry-over of $175,740.56 would be sufficient to make up the amount by which the rental at $5.00 per thousand for such future years

would be less than the rental generated under the present formula.

The foregoing suggests the possibility of amending the lease to provide for rental at $5.00 per thousand feet of lumber manufactured by Fortuna Sawmills, Inc., subject to the limitation that such rental payments for any fiscal year cannot exceed 80% of net income, with any excess or rental at $5.00 per thousand over the 80% of net income limitation to be carried over to future years subject to the before-mentioned 80% limitation in the future years. While the amendment could be made as of April 30, 1954, it would provide that the rental for the prior years and the carry-over would be computed just as if the amendment were in effect from the inception of the lease. The rental for the fiscal year ended April 30, 1953 and the fiscal year ended April 30, 1954 would be the same under the amendment as under the present formula because the 80% of net profit limitation applies in view of the fact that such 80% is less than the rent computed at $5.00 per thousand. There would then be carried over to the current fiscal year the excess of the rent computed at $5.00 per thousand over the 80% of net profit limitation. This carry-over would permit as much rental to be paid at $5.00 per thousand as would be paid under the present formula since the rental at $5.00 per thousand for the current fiscal year plus the carry-over from the preceding years is greater than the 80% of net profit limitation. There is even the above-mentioned $175,740.56 carry-over to fiscal years after April 30, 1955.

Amendment of the lease in accordance with the foregoing would not result in any less rental up through the current fiscal year and will not result in any less rental for the remaining term of the lease unless Fortuna Sawmills, Inc., does substantially better in the future years than during the current year. In view of the favorable effect of the strike this year, it seems unrealistic to expect that future years will be any better than the current one. Even if Fortuna Sawmills, Inc. should do substantially better
312 in the future years so that less rental will be payable at the rate of $5.00 per thousand than under the present formula, we believe the advantages to be gained are worth any such possible deficiency in rental.

The fact that rental at $5.00 per thousand generates an amount approximating the rental payable under the present lease seems to indicate the reasonableness of the rental provision under the present lease. On the other hand, the similarity of the two rentals may be attributed to the reduced profits in the previous years which gives a substantial carry-over to subsequent years. Even if the rental at $5.00 per thousand generates an amount approximating what is payable under a rental of 80% of net income, and even though such may be interpreted as proof that 80% of net rental is fair, we believe there are advantages to amending the lease along the suggested lines. Rental at $5.00 per thousand feet on lumber manufactured in the mill is easier to substantiate as a reasonable rental arrangement, especially in view of your statement that it should be possible if the need arises to obtain testimony from competent lumbermen that such is a reasonable rental. Also, such a rental arrangement differs from the procedure outlined in the Bureau's ruling. We believe there is considerable advantage in having a rental agreement which does not follow the more or less standardized form of 80% of net profits. Limiting rentals at $5.00 per thousand to a ceiling of 80% of net profits with a carry-over provision should not detract from the fact that the lease amended along the suggested lines would primarily and basically be a lease providing for rental of a flat amount per unit of production, rather than rental based entirely on a percentage of net income. Where the rental is not based primarily on a percentage of income, it is much more difficult for the government to contend that the so-called rental payments are a return of profits by a company operating the property for the benefit of the tax-exempt organization, or to contend that the payments are a share of profits retained by the tax-exempt organization as a partner or a joint venturer.

We strongly recommend that the lease between Fortuna and the Institute be amended as suggested above. The lease should also be amended to eliminate the requirement of a management contract with you. Your recent acceptance of a position with M. & M. makes such an amendment necessary even if it were not considered advisable for tax purposes.

Before anything more can be done to carry out our suggestions, it will be necessary to obtain the approval of the California Institute. Two extra copies of this letter are enclosed which you may forward to the Institute in
313 requesting the suggested change. We understand that a payment will be due under the lease in the near future and we strongly advise that any amendment be accomplished in time so that such payment may be made under the revised lease, even if it is necessary to hold up the payments.

Since the revision of the lease should be for the mutual benefit of you and the Institute, we do not anticipate any objection from the Institute. When you have obtained their approval and received information as to who will handle the revision on their behalf we shall be glad to get together with them either here in Portland or in Los Angeles as soon as possible. If, for any reason, the Institute should not desire to go along with the suggested changes, then we believe that before making the next rental payment you should receive assurance from them that they will pay any taxes assessed against them on the rental from other sources of income so that you will receive the full amount upon the purchase price for your stock as specified in the stock sales agreement.

Very truly yours,

WILLIAM H. KINSEY
William H. Kinsey

WHK AML
Encl.

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Analysis of Rent as accrued at 80% of earnings (before rent and taxes) compared with rent which would have accrued at $5.00 per M' of shipment

Period Covered	Footage Shipped	Earnings before rent and taxes	Rent as accrued	Rent which would have accrued @ $5.00 per M' shipped
Fiscal Year ended 4/30/53 (3 mos)	10,304,767'	$ 46,206.91	$ 36,965.53	$ 51,523.84
Fiscal Year ended 4/30/54 (12 mos)	46,112,821'	(4,748.23)	7,476.84*	230,546.11
Current Fiscal Year to date (5 mos)	27,334,843	294,463.84	226,579.24	136,674.22
Balance Fiscal Year to 4/30/55 (estimated)	28,000,000	140,000.00	112,000.00	140,000.00
Total Fiscal Year ended 4/30/55	55,334,843	434,463.84	338,579.24	276,674.22
Total All Years, 2/1/53 to 4/30/55	111,752,431	$475,922.52	$383,021.61	$558,762.17

* Overpayment—adjusted following year.

315 **Exhibit 58-FFF**

Memo to Clay Brown
from Wilbur, Mautz, Souther & Spaulding

Re: Proposal of California Institute for Cancer Research

You have asked our opinion in regard to the proposal of the Institute to purchase the stock of Clay Brown & Company. From the information you supplied us we understand that the essentials of the proposal are as follows:

1. The Institute will purchase all of the stock of Clay Brown & Company for X Dollars. One Hundred Thousand ($100,000) Dollars of the purchase price will be paid down with the balance to be evidenced by a promissory note secured by real and chattel mortgages on the assets of Clay Brown & Company received by the Institute upon the liquidation of the Company.

2. Clay Brown & Company will then be dissolved and the Institute will receive all the assets thereof upon dissolution.

3. The $100,000 down payment will be made from the assets received by the Institute on liquidation.

4. Although not mentioned in the information you supplied us, we assume that the liability of the Institute to pay the balance of the purchase price for your stock will be limited to the income it realizes from the assets of Clay Brown & Company received by it on dissolution.

5. The Institute will not operate the business itself, but instead will:

(a) Sell the current position to a new corporation for which the Institute will receive the note of the new corporation.

(b) Lease the balance of the assets to the new corporation under a lease providing for the payment to the Institute of rental equal to 80 per cent of net income of the new corporation before taxes.

6. The Institute will retain 10 per cent of the rent received by it from the new corporation, and will apply the balance (90 per cent) upon the unpaid purchase price for the stock.

7. The new corporation will be capitalized for $25,000 of which you buy 45 per cent of the stock and your friends (not family) purchase the balance.

8. You will be employed by the new corporation as general manager.

316 9. The proposal does not state over what period of time the balance of the purchase price is to be paid but we understand five years has been mentioned. We assume that the lease of the assets by the Institute to the new corporation will be for a period of not more than five years.

We understand that the proposal is based upon the assumption that the following income tax consequences

will be derived from the plan, and therefore the advisability of the plan depends upon the validity of these assumptions:

(a) The price you receive for your stock of Clay Brown & Company (the original down payment plus the subsequent payments) will be capital gain to you, and that you will be able to report such capital gain upon the installment basis.

(b) The new corporation will be able to deduct for income tax purposes the rental (80 per cent of net income before taxes) paid to the Institute under the lease, and such rental payments received by the Institute will be exempt and not subject to income tax.

The validity of assumption (a) above is of primary importance to you. The validity of assumption (b) is more a problem of the Institute but nevertheless is of importance to you since it vitally affects the ability of the Institute to pay the balance of the purchase price for the stock. There follows a review of our opinion concerning the beforementioned tax assumptions.

(a) *Will you be entitled to capital gain treatment and to report such gain on the installment basis?*

Under the proposal you will be selling your stock in Clay Brown & Company which you have held for more than six months, so it would seem that you should be entitled to report as a long term capital gain the amount received by you upon the sale of the stock. If this is so, you should be able to report such gain on the installment basis. The problem then is to determine whether there is any theory under which the Commissioner might contend that there was not a sale of the stock entitling you to capital gain treatment. A point of possible attack is the reorganization provisions of the Internal Revenue Code. If you acquire 80 per cent or more of the stock of the new
317 corporation there would be a definite danger that there might be what is known as a Clause (D) reorganization under Section 112 of the Code. If there is

such a reorganization, either of two dangerous consequences would result:

(a) The gain received by you upon the sale of the stock could not be reported on the installment bases and all of the gain would be taxed to you in the year of sale.

(b) Worse yet, the portion of the gain not in excess of the accumulated profits of Clay Brown & Company would be taxed to you as a dividend under I.R.C. Sec. 112(c)(2).

As before stated, the danger is substantial if you acquire 80 per cent or more of the stock of the new corporation. Exactly why this is true involves the intricacies of the reorganization provisions of the Code and we will be glad to explain them to you further if you so desire. We realize that the proposal provides that you will own only 45 per cent of the stock of the new corporation and that the balance will be acquired by your friends. The danger here is that if it could be successfully contended that your friends really held the stock for you, then it would be the same as if you owned it. Stock owned by your wife or children is also considered as stock owned by you.

If more than 20 per cent of the stock of the new corporation is definitely owned by independent third persons, will be the foregoing dangerous tax consequences be eliminated? We believe there is a good chance they would be eliminated but to be on the safe side we would prefer that you owned no stock in the new corporation whatsoever. In short, the proposal has tax dangers unless you are resigned to the fact that the new corporation which will operate the business will be controlled by independent third persons and that you will be unable to control same either directly or indirectly. You may have a management contract with the new corporation, but you should realize that it could be terminated by the new corporation at any time leaving you with whatever action you may have for damages against the new corporation. Your continuance as manager of the new corporation should not be a condition of the sale of the stock by you to the Institute.

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The more the deal is a straight sale of the stock of Clay Brown & Company by you, the better your tax position. It is all right if the down payment is obtained from the assets of Clay Brown & Company received upon dissolution, and if the unpaid balance is secured by real and chattel mortgages on the assets. Likewise it is all right if the payment of the unpaid balance is limited to moneys received by the Institute in the operation of the business. None of these features conflict with an outright bona fide sale of the stock by you. The danger arises when you maintain an interest in the operation of the business for reasons other than security for the unpaid balance of the purchase price for the stock. Your acquisition of a stock interest in the new corporation seems to have little connection with security for the purchase price. The management contract has more of a relationship to security since you have a definite interest in the management of the business inasmuch as the payment of the balance of the purchase price for your stock is limited to payment from income realized from the business. However, your being general manager gives you certain control over the new corporation which might be considered to be the same as control through stock ownership. This danger is minimized if the management contract does not extend beyond the full payment of the purchase price for the stock, and if the management contract is not tied in as a definite condition in the sale of the stock. The sale of your stock could be conditioned merely upon the furnishing of management for the business satisfactory to you until the stock is fully paid for. The management contract should be a separate contract between the new corporation and you.

If our suggestions are followed, your only security for the unpaid balance of the price for your stock would
319 be the real and chattel mortgages. These mortgages would not cover what is referred to as the "current position" in the Institute proposal. We assume the current position means the excess of current assets (including inventory) over current liabilities. It would be best, of course, if the down payment for the stock could equal this current position so that it would not be necessary to secure payment for same, and the real and chattel mortgages would be sufficient security to cover the unpaid balance of

the purchase price. If the down payment cannot be this much, then under the Institute proposal the new corporation would give its note to the Institute for the current position and this note in turn would be deposited with you as additional security for the unpaid balance of the purchase price. Such unsecured note of the new corporation is not too good security so it probably would be necessary to have the stock of the new corporation deposited in escrow as security for the note of the new corporation and this stock could be in turn assigned to you by the Institute together with the note. We would prefer some other type of security for the current position which would make it unnecessary for you to have the stock of the new corporation even as additional security. Such security might take the form of an assignment of accounts receivable.

In summary, we believe that under the present federal income tax law you should be entitled to capital gain treatment on the sale of your stock under the Institute proposal, particularly if you own no stock whatsoever in the new corporation. If you purchase no stock of the new corporation, there may be a problem as to how the new corporation will be capitalized. Any funds required by the new corporation over and above the amounts paid for its stock by the independent stockholders could be obtained by a bank loan. It might be necessary for you to
320 guarantee such loan. We would rather have you guarantee a bank loan than have you make a loan directly to the new corporation.

We are familiar with an instance here in Portland where stock in a business was sold to an institution under a setup quite similar to that proposed to you. The selling stockholders obtained approximately a thirty per cent stock interest in the new lessee corporation. This deal was consummated just a little over a year ago so it has not been reviewed by the Treasury Department. In the absence of definite approval by the Treasury Department either through a special ruling or by approval of a similar deal, we advise that you do not own any stock in the new corporation.

Will the rental be fully deductible by the new corporation and exempt when received by the Institute?

We understand that the feature which makes the proposal of the Institute possible is the fact that the new corporation will be able to deduct the rental payments paid the Institute but yet such rental payments will be exempt from taxation when received by the Institute. If it were not for this tax exemption status of the Institute, the deal could just as easily be worked out without the Institute. For example, some third persons could organize a new corporation and have the new corporation purchase all of your stock in Clay Brown & Company, dissolve Clay Brown & Company, make a down payment on the stock out of the assets received upon dissolution, and pay the balance out of the profits secured by real and chattel mortgages. Such new corporation would not be able to deduct the payments made on the purchase price for the stock, so the profits used to pay the purchase price would be subject to income taxes.

321 As before stated, the advantage of the Institute proposal is that the profits used to pay the balance of the purchase price for the stock is supposedly never subjected to income taxes. This is accomplished by having 80 per cent of the profits of the new corporation paid to the Institute in the form of rent. Such rent will be deducted by the new corporation and therefore will not be taxed to it. Rent deducted by the lessee does not escape taxation if the rent is taxable to the lessor as is the case involving an ordinary lessor. However, if the lessor is tax-exempt and the rent is not taxed to it, then the rent (and the profits with which it was paid by the lessee) is never subject to income tax. We understand that the Institute's proposal is based upon the assumption that the rent will be deductible by the new lessee corporation but the income tax exemption of the Institute will preclude taxation of such rent when received by the Institute.

Is there any reason to doubt the tax exemption assumptions mentioned in the preceding paragraph? First, the Commissioner might contend that the 80 per cent of the net profit payable by the new corporation is not really rent. There might be some merit to this contention if 80 per

cent of the profit is more than what a reasonable person would agree to pay as rental for the assets under arms length bargaining. Second, the Commissioner might contend that the rental payments received by the Institute are subject to income taxes on the theory that such income is "unrelated business net income" which is subjected to income taxes under amendments to the income tax law accomplished by the Revenue Act of 1950. The Commissioner probably would not argue that the rental is not deductible by the new corporation and also that such rental is taxable to the Institute, although there might be some possible theory under which this contention could be made. More likely the Commissioner would argue either one or
322 the other, whichever one he thought offered the greatest possibility of success.

In our opinion the Commissioner will be most likely to argue that the rental payments received by the Institute are taxable to it under I.R.C. Sec. 421 which imposes a normal tax of 30 per cent of Supplement "U" net income and a surtax of 22 percent of Supplement "U" net income in excess of $25,000. The Supplement "U" net income is defined to be the amount by which the Institute's unrelated business net income exceeds $1,000. In other words, if the rental payments received by the Institute constitute unrelated business income, such rentals after deduction for depreciation, etc. are taxable to the Institute at the same rate as the normal and surtax applicable to ordinary corporations (except for the $1,000 exemption).

Would the rental payments constitute unrelated business income? Such rental payments are certainly unrelated to the regular business of the Institute, so it would be subject to tax unless covered by a specific exclusion. Exclusion from unrelated business net income are contained in the subparagraphs of Section 422. One of the exemptions covers rents from real property (including personal property leased with the real property), except for rental from a Supplement "U" lease. Another exemption excludes royalties and contains the phrase "whether measured by production or by gross or net income from the property". The exclusion applicable to rentals does not contain such a provision which might lend substance to the inference that excluded rentals does not include payments based on

a percentage of net income such as the rentals which would be payable by the new corporation to the Institute.

In the instance which we referred to above where a Portland business was sold under a similar deal, some patents were involved so the payments to the institution there involved included royalties as well as rents.
323 As above noted, royalties are excluded from unrelated income even though measured by net income. This may or may not be true of rentals.

Also to be considered is whether the rental would be rental from a Supplement "U" lease. As before stated, if the lease from the new corporation to the Institute is a Supplemental "U" lease, then the rentals thereon received by the Institute would be unrelated income and subject to tax. A Supplement "U" lease is defined in Sec. 423 to be a lease for a term of more than five years where an indebtedness was incurred by the lessor in acquiring or improving the property leased.

The Institute would incur an indebtedness to you for the assets leased to the new corporation, so the lease would be a Supplement "U" lease if it is for a term of more than five years. In computing the term of a lease which contains an option for renewal or extension, the term of such lease shall be considered as including any period for which such option may be exercised. Therefore the lease from the Institute to the new corporation cannot be for a period of more than five years including any options for renewal. Even if there was no express option for renewal if the deal had circumstances which made it very incumbent upon the lessor to extend the lease such might be interpreted as being an option of renewal. If the lease from the Institute to the new corporation is for not more than five years, there is still the above-mentioned possibility that the rental would be unrelated income and subject to tax when received by the Institute.

The Institute has undoubtedly had some research done on this question and may have some rulings from the Commissioner. The law is relatively new so there are no cases as yet. Based purely on a reading of the statute and the applicable regulations which do little more than paraphrase the statute, we believe there is a serious question of
324 whether the rentals received by the Institute from the new corporation would be subject to tax.

If the rentals are subject to tax when received by the Institute, how will this effect the deal? Would the Institute nevertheless have to pay to you 90 per cent of the rent received and pay the taxes thereon out of the 10 per cent of the rent to be retained by the Institute plus any other funds of the Institute necessary to make up the tax? Or would such taxes reduce the 90 per cent payable to you? On the other hand the taxes might be paid out of the rentals received and the amount remaining after taxes would be distributed 90 per cent to you and 10 per cent retained by the Institute. If the 90 per cent is paid to you after taxes, this will reduce the payments and prolong the time it will take to pay up the unpaid balance for your stock. You then would not be in a much better position than if you sold your stock to an ordinary corporation formed for the purpose of purchasing your stock and taking over the assets upon liquidation.

Since the proposal of the Institute assumes that there will be no taxes payable by it on the 80 per cent of the profits of the new corporation received as rent, the Institute may be willing to agree that 90 per cent of such rent shall be applied against the purchase price for the stock before any income taxes which might be assessed. In any event, this is a point to be covered with the Institute. If the Institute is not willing to absorb any taxes which might be assessed on the rentals recevied by it from the new corporation, we would advise that you do not enter into the deal without first having obtained a definite ruling from the Treasury Department that such rentals would not be taxed to the Institute. As before stated, the Institute may already have obtained such a ruling.

Summary

In summary of the foregoing, we are of the opinion that there is a possibility the 80 per cent of the profits
324a to be paid by the new corporation to the Institute in the form of rental might be taxed to the Institute. Therefore, if the deal is premised upon such rental payments being exempt when received by the Institute, we would advise that a ruling be obtained from the Treasury Department. Also, some provisions should be made as to what would happen if the law should change in the future

so as to subject such rental payments to taxation if they are exempt under the present law.

Assuming that the problem mentioned in the preceding paragraph is met, we believe the deal can be worked out in such manner as to accomplish the capital gain tax results desired by you, but as above mentioned we advise that you acquire no stock interest whatsoever in the new corporation and suggest that the other beforementioned modifications of the Institute's proposal should be made.

There is one more problem that probably should be considered. As before noted, the lease from the Institute to the new corporation cannot be for more than five years and cannot contain an option for renewal. What will happen if the unpaid balance of the purchase price for your stock has not been paid upon the expiration of the five-year lease? It might be provided that if your stock is not all paid for out of the 90 per cent of the rents to be received by the Institute then the obligation to pay the remaining balance shall become a fixed obligation of so much per month or year irrespective of income.

Exhibit 73-UUU

Period Covered	1 Fortuna Net Profit Before Rent and Income Taxes — Semi-Annual	2 Fortuna Net Profit Before Rent and Income Taxes — By Fiscal Years	3 Payments by Fortuna To Institute Per Lease and License Agreement — 80% of Net Profit — Semi-Annual	4 Payments by Fortuna To Institute Per Lease and License Agreement — 80% of Net Profit — By Fiscal Years	5 Payments by Fortuna To Institute Per Lease and License Agreement — Other	6 Payments by Institute on Promissory Notes — Applied on Brown Notes	7 Payments by Institute on Promissory Notes — Applied on Stock
Feb. 4, 1953 (down payment)						3,637.50	1,362.50
Feb. 4, 1953 to April 30, 1953	46,206.91		36,945.53			25,050.74	8,200.24
Total, fiscal year ended 4/30/53		46,206.91		36,945.53			
May 1, 1953 to Oct. 31, 1953	9,346.05		7,496.84		1,796.08(1)	6,407.43	2,135.81
Nov. 1, 1953 to Apr. 30, 1954	⟨ 14,094.28 ⟩				5,285.90(2)	3,964.42	1,321.48
Total, fiscal year ended 4/30/54		⟨ 4,748.23 ⟩		7,496.84			
May 1, 1954 to Oct. 31, 1954	347,516.66		150,000.00			85,939.91	49,060.09
Nov. 1, 1954 to Apr. 30, 1955	174,068.50		246,019.61		4,098.00(3)		225,515.65
Total, fiscal year ended 4/30/55		521,585.16		396,019.61			
May 1, 1955 to Oct. 31, 1955	263,010.45		100,000.00		1,450.00(4)		91,450.00
Nov. 1, 1955 to Apr. 30, 1956	68,857.39		163,387.55				147,048.80
Total, fiscal year ended 4/30/56		331,867.84		263,387.55			
May 1, 1956 to Oct. 31, 9156	118,610.47						
Nov. 1, 1956 to Apr. 30, 1957	⟨ 125,346.89 ⟩		142.50*				
Total, fiscal year ended 4/30/57		⟨ 6,736.42 ⟩		142.50*			
SUB-TOTALS	888,175.26	888,175.26	703,992.03	703,992.03	12,629.98	125,000.00	526,094.57
May 1, 1957 to Oct. 31, 1957	⟨ 83,681.21 ⟩						
Nov. 1, 1957 to Apr. 30, 1958					20,849.29(5)		20,849.29
May 1, 1958 to Oct. 31, 1958					989.00(6)		989.00
Nov. 1, 1958 to Apr. 30, 1959							
May 1, 1959 to Oct. 31, 1959					1,102.50(7)		1,102.50
					35,570.77	125,000.00	549,035.36
					Plus paid on Brown Notes		125,000.00
							674,035.36
					Proceeds of sale to California Highway Dept.		262,096.49
					Total paid by Institute on Promissory Note and Brown Notes		936,131.85
					Total Promissory Note		1,300,000.00
					Less Payments		936,131.85
					Unrecovered on Promissory Note		363,868.15

* 142.50 erroneously overpaid rent--later corrected. See Item (5).

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Notes applicable to Column 5

(1) Workmens' Compensation Dividend for Industrial Indemnity Company for period Dec. 1, 1950 to Dec. 1, 1951		1,796.08
(2) Workmens' Compensation Dividend for period Dec. 1, 1951 to Dec. 1, 1952	84.23	
Proceeds from sale of capital assets	5,201.67	5,285.90
(3) Proceeds from sale of capital assets		4,098.00
(4) Proceeds from sale of capital assets		1,450.00
(5) Settlement of promissory note given by Fortuna to the Institute representing excess of current assets over current liabilities	20,991.79	
Less overpayment of rent for fiscal year ended 4/30/57	142.50	20,849.29
(6) Proceeds from sale of capital assets		989.00
(7) Proceeds from granting right-of-way across mille premises to Pacific Gas & Electric Co.	247.50	
Sale of capital assets	855.00	1,102.50
		35,570.77

Exhibit 32-DDDD

327 CLAY BROWN & COMPANY

BALANCE SHEET
January 31, 1953, and

STATEMENT OF EARNINGS AND RETAINED EARNINGS
Nine Months ended January 31, 1953

ACCOUNTANTS' REPORT

328 PEAT, MARWICK, MITCHELL & CO.
AMERICAN BANK BUILDING
PORTLAND 5, OREGON

ACCOUNTANTS' REPORT

The Board of Directors
Clay Brown & Company

We have examined the balance sheet of Clay Brown & Company as of January 31, 1953 and the related statement of earnings and retained earnings for the nine months then

ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The cash and bank balances have been confirmed by count or by confirmation obtained direct from the depositaries.

We issued requests to customers for confirmation of accounts receivable comprising approximately 98% of the total. All exceptions reported were explained to our satisfaction. The notes and accounts receivable from customers and others were reviewed as to age and collectibility and, in our opinion, reasonable provision has been made for probable losses.

Of the total log inventory, logs having a carrying value of $376,491.66 are stated in accordance with warehouse receipts issued by the Lawrence Warehouse Company, which has physical custody of logs pledged as collateral security to the bank. The remainder of the log inventory and lumber quantities are stated in accordance with physical inventories taken by employees of the company. The inventories were valued by employees of the company under direction of the management and we obtained a certificate from an official of the company as to their description, quantities, condition and valuation. As to the warehoused logs, we relied as to the quantities on a certificate obtained directly from the warehouse company after making such supplemental inquiries as we deemed necessary. We made tests of the physical existence of the quantities of certain items selected by us and observed the inventory taking in reference to the lumber and that portion of the log inventories not warehoused. Logs and lumber are stated at the lower of average cost or market and we tested the prices and computations, satisfying ourselves as to the general basis of valuation.

329 Expenditures charged to the property, plant and equipment accounts during the period, in our opinion, were properly capitalized as representing additions and improvements. The allowance for depreciation for the period appears to be reasonable.

In our opinion, the accompanying balance sheet and statement of earnings and retained earnings present fairly the financial position of Clay Brown & Company at January 31, 1953 and the results of its operations for the nine months then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

PEAT, MARWICK, MITCHELL & Co.

Portland, Oregon
April 7, 1953

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CLAY BROWN & COMPANY

BALANCE SHEET

January 31, 1953

ASSETS

Current assets:		
Cash		$ 30,738.41
Accounts and notes receivable, less allowance for doubtful accounts:		
Accounts receivable—trade	$115,493.60	
Sundry accounts and notes receivable	4,162.60	
	119,656.20	
Less allowance for doubtful accounts	2,323.44	117,332.76
Inventories—at the lower of average cost or market (note 1):		
Logs (logs carried at $376,491.66 pledged as security for bank loan, per contra)	419,375.11	
Lumber	38,737.33	458,112.44
Prepaid expenses:		
Insurance	9,388.37	
Falling and bucking costs	1,543.74	10,932.11
Total current assets		617,115.72
Plant and equipment—at cost less depreciation:		
Fortuna, California plant (note 2):		
Land	24,635.27	
Buildings	173,520.45	
Equipment and facilities	415,379.26	
Automotive equipment	21,738.63	
Furniture and fixtures	5,057.81	
Total Fortuna, California plant	640,331.42	
Sales offices—automobile and furniture	14,328.62	
	654,660.04	
Less accumulated allowance for depreciation	108,743.98	545,916.06
Timber—at cost, less depletion		47,549.78
Deposits		51.00
		$1,210,632.56

See accompanying notes to financial statements, which are an integral part of this statement.

January 31, 1953
BALANCE SHEET
CLAY BROWN & COMPANY

LIABILITIES

Current liabilities:			
Demand notes payable to bank (secured by pledge of logs carried at $376,491.66, per contra)			$ 269,265.00
Portion of long-term debt due within one year (note 2)			43,531.31
Accounts payable—trade			32,263.30
Accrued payroll, taxes, interest, etc.			28,114.05
Federal taxes on income:			
Final installment—preceding year		$ 10,109.06	
Estimate for current year		116,280.92	126,389.98
Total current liabilities			499,563.64
Long-term debt, exclusive of notes payable to stockholders (note 2):			

	Total	Current portion	
Timber purchase contract	$ 32,541.46	2,581.32	
Mortgage note payable to bank	100,871.09	39,219.94	
Deferred insurance premiums	1,730.05	1,730.05	
	135,142.60	43,531.31	91,611.29
Demand notes payable to stockholders (subordinated to mortgage note payable—note 2)			125,000.00
Stockholders' equity (note 3):			
Common capital stock of $1.00 par value per share, authorized 50,000 shares; issued and outstading, 32,000 shares		32,000.00	
Capital surplus (no change during period)		13,986.00	
Retained earnings		448,471.63	
			494,457.63
			$1,210,632.56

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CLAY BROWN & COMPANY

STATEMENT OF EARNINGS AND RETAINED EARNINGS

Nine Months ended January 31, 1953

Net sales	$2,089,786.82
Cost of sales	1,696,628.28
	393,158.54
Earnings of wholesale department	448.11
Gross income	393,606.65
Selling, general and administrative expenses	166,722.03
Operating earnings	226,884.62
Other income	1,038.83
	227,923.45
Interest on notes payable	14,697.91
Earnings before Federal Taxes on income	213,225.54
Federal taxes on income (including $15,198.67 excess profits tax)	116,550.01
Net earnings	96,675.53
Retained earnings at April 30, 1952	351,796.10
Retained earnings at January 31, 1953	$ 448,471.63

Note: The allowance for depreciation for the period amounted to $37,228.34, and the allowance for depletion of timber amounted to $28,053.77.

See accompanying notes to Financial Statements, which are an integral part of this statement.

CLAY BROWN & COMPANY

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NOTES TO FINANCIAL STATEMENTS

Note 1. Inventories:

Logs carried on the books at $376,491.66 are stated in accordance with field warehouse receipts. The remainder of the log inventory together with the lumber quantities are stated pursuant to physical inventories.

Note 2. Long-Term Debt:

The timber purchase contract is payable as timber is cut and removed, subject to a minimum quarterly payment of $4,280 less credit for excess cut in prior quarters.

The mortgage note payable to bank is secured by a real and chattel mortgage on the Fortuna, California plant. The note is payable in installments of $1,800 monthly, including interest, and the balance on or before June 15, 1960. In addition to the monthly installments an accelerated payment of principal and interest is payable on June 30 of each year equal to fifty

per cent of the annual net earnings before depreciation and after taxes and after deducting the aggregate amount of principal payments made during the previous fiscal year. The bank, however, has waived this accelerated payment with respect to earnings for the period ended January 31, 1953 and has agreed to accept instead, $3,600 monthly including interest for the twelve succeeding months. The current portion of this loan has, therefore, been computed on that basis. As of February 4, 1953 the Company technically violated the terms of the loan agreement through the dissolution described in Note 3. To date no demand for payment has been made because of the non-compliance with terms of the loan agreement.

The notes payable to stockholders, although payable on demand, have been subordinated to the mortgage note payable to the bank by agreements dated October 29, 1949, and under the terms of said agreements no portion of principal may be paid so long as any portion of the mortgage note to the bank remains outstanding.

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Note 3. Dissolution:

On February 4, 1953, pursuant to approval of its stockholder and resolution of the Directors, Clay Brown & Company was formally dissolved. Upon such dissolution all of the assets and liabilities of the corporation were transferred to the sole stockholder of the Corporation on that date as a liquidating dividened. Immediately thereafter all of the current assets subject to all liabilities, except notes payable to the former stockholders, $125,000.00, were sold and the plant and equipment leased to Fortuna Sawmills, Inc., which company will operate the properties.

Exhibit 84-FFFF

334 January 7, 1953

Mr. C. W. Booth Secretary-Treasurer
Clay Brown & Company
U. S. National Bank Bldg.
Portland 4, Oregon

Dear Mr. Booth:

I am sorry to be so long in answering your letter of December 22nd but the holidays and several absences from the city put me a long way behind in my correspondence.

First of all I received the audited statement of Peat, Marwick, Mitchell & Co., dated April 30, 1952, for which I thank you. I should like, also, to have the supplemental details for that same date in the unaudited form, including the six schedules you mentioned in your letter of December 22nd, which you kindly volunteered to send me.

The ProForma Statement of Assets of October 31, 1952, in which the revised values were substituted, and the item-

ized schedule B, which makes the substitutions entirely clear, were also received and very much appreciated.

As to companies with which deals have been completed, my suggestion is that the one of most interest to you would be that of the White Pine Lumber Company in Reno, Nevada, which was sold to Loyola University and handled by Paul Cote'. Probably you or Mr. Brown know the principals connected with that company.

Another suggestion is the name of Dana Latham, a leading tax attorney in Los Angeles, whose present offices are in the Statler Building, 900 Wilshire Blvd., Los Angeles.

335 He has been familiar with this type of transaction for a good many years, and I believe, with Mr. Cote' handled the sale of the U. S. Grant Hotel, as well as the more recent sale of the Allied Recorder Company. He is also counsel for another company, the name of which I am not yet free to give you but it may be that you or your lawyers would like to contact him and ask him a few questions. I understand from Mr. Cote' that Mr. Souther did talk to him, in particular concerning the ownership of a new operating company.

I am of the opinion that it would be, as you suggest, a good idea to bring the appraisal up to date, if we arrange a basis for a deal. I hope it will not be too expensive. Thank you very much for your careful attention to my requests.

I will not be in the office after Friday, and will be in Portland the fore part of next week, so you may as well hold the supplementary sheets to your company statement of April 30, 1952, and hand them to me when we meet in Portland.

You probably now have the company statement for November 30th and may have some preliminary idea of results for December. These figures, of course, I would like to know though I realize that these months, and December in particular, are off-season and that the earnings for this

half year will probably occur in the first four months of this fiscal year.

Kindest regards.

Sincerely yours,

L. H. SEAGRAVE

LHS:HL
cc: Mr. Clay Brown

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336 January 7, 1953

Mr. Clay Brown
President
Clay Brown & Company
U. S. National Bank Building
Portland 4, Oregon

Dear Mr. Brown:

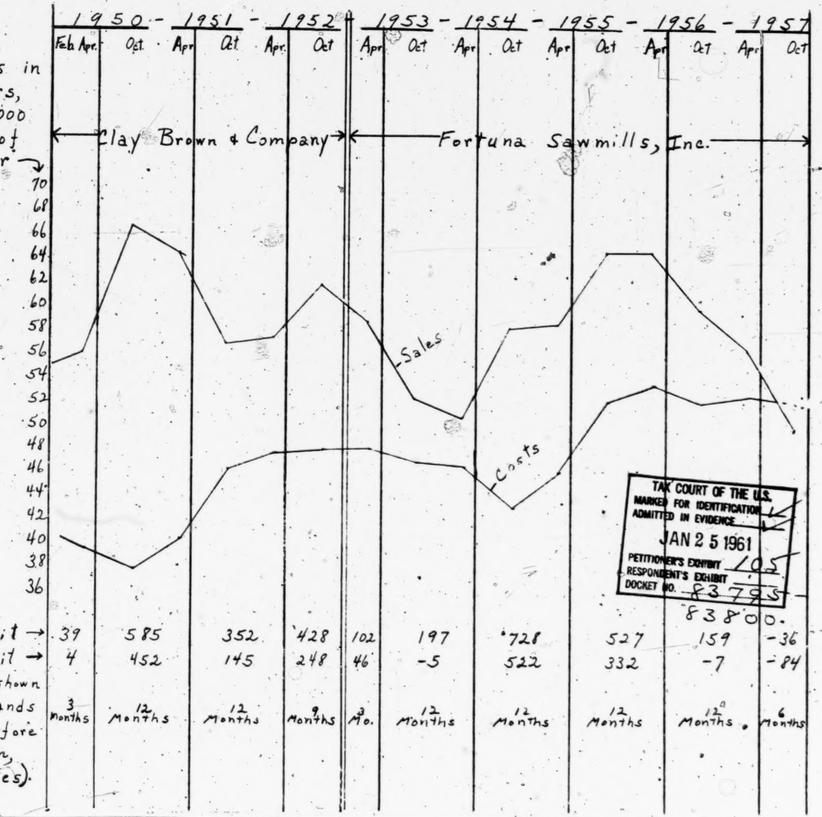
I understand from Mr. Guy Witter that Mr. Boone has arranged for a meeting at your Portland office with you and your lawyer. He sent word that I would be there Tuesday morning at 10:00 o'clock. However, I shall leave here on Friday evening or Saturday as I have several engagements enroute.

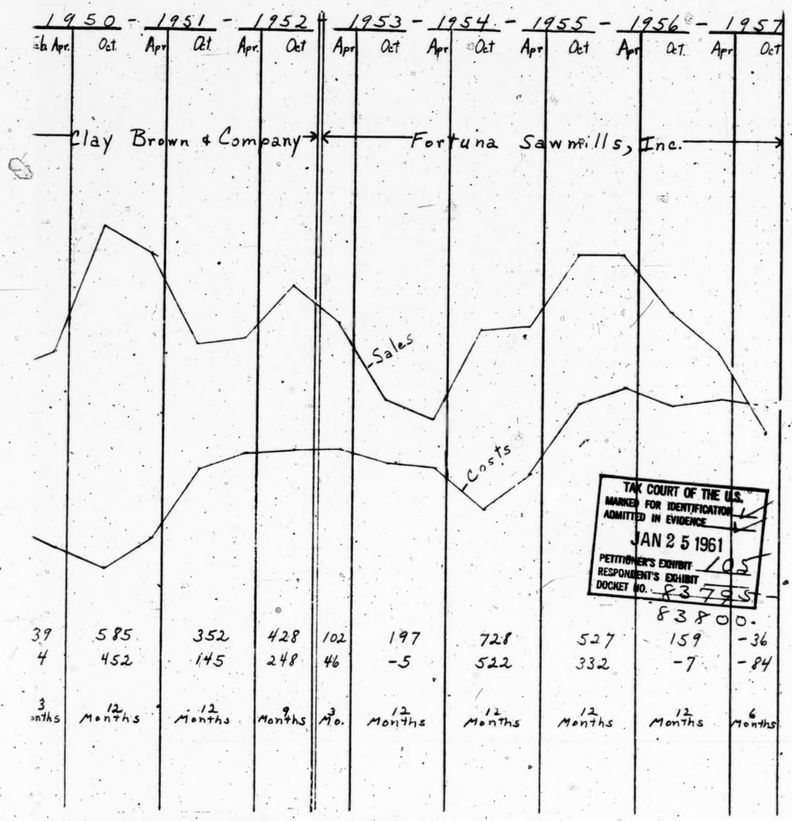
I expect to arrive in Portland late Sunday. I will be at the Benson but will be tied up all day Monday. My present plan is to leave Portland on the non-stop plane to Los Angeles, which I believe leaves there at 2:30 P.M. on Wednesday.

Sincerely,

L. H. SEAGRAVE

LHS:HL





Clay Brown & Company
and
Fortuna Sawmills, Inc.

Graph showing relationship of manufacturing costs to selling prices, and their influence on profits.

— Top = Net sales average (After deducting freight and discounts).

— Bottom = Direct costs per thousand feet board measure to manufacture lumber (Including cost of logs — less depreciation and rent).

1-20-61

338 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Nos. 18228-18233

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CLAY B. BROWN, ET AL., *Respondents*.

Statement of Points—Filed October 1, 1962

Pursuant to Rule 17.6 of the Rules of this Court, petitioner hereby states that he intends to rely upon the following points on review of these consolidated cases:

1. The Tax Court erred in holding and deciding that the taxpayers realized long-term capital gains rather than ordinary income on the purported sale of their stock to a tax-exempt corporation.

2. If the Tax Court's holding that the transaction involved was a bona fide sale constitutes a conclusion of law, the Tax Court erred as a matter of law.

3. If the Tax Court's holding that the transaction involved was a bona fide sale constitutes an ultimate finding of fact, such finding was clearly erroneous under established standards of review.

4. The Tax Court erred in entering decisions for the taxpayers.

/s/ LOUIS F. OBERDORFER,
Assistant Attorney General,
Counsel for the Petitioner.

Dated this 28th day of September, 1962.

(File endorsement omitted)

339 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Stipulation—Filed October 8, 1962

It is hereby stipulated by and between the parties hereto that, subject to approval by the Court, the docket entries and all exhibits forming a part of the record on appeal herein shall be presented in their original form rather than being printed, and that the parties in their briefs may refer to the docket entries and exhibits to the same extent and effect as if they had been printed.

Dated:

/s/ LOUIS F. OBERDORFER,
Assistant Attorney General,
Attorney for the Petitioner.

/s/ WILLIAM H. KINSEY,
Attorney for the Respondents.

So Ordered: October 8, 1962.

/s/ RICHARD H. CHAMBERS
Circuit Judge.

340 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Dec. 10, 1963

Nos. 18,228-18,233

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILIP F. BROWN, MARILYN BROWN, *Respondents*.

Petition to Review a Decision of the
Tax Court of the United States

Before: HAMLIN and DUNIWAY, Circuit Judges
and
KUNZEL, District Judge

DUNIWAY, Circuit Judge:

The Commissioner of Internal Revenue asks us to reverse decisions of the Tax Court. We are of the opinion that the decisions must be affirmed.

Involved is a transaction of the type described by Moore and Dohan in an article entitled: "Sales, Churches and Monkeyshines," 11 Tax L. Rev. 87 (1956), and by Lanning in an article entitled: "Tax Erosion and the 'Bootstrap sale' of a Business," 108 U. of Pa. L. Rev. 623 (1960). The transaction is described in great detail in the findings of the Tax Court, which are reported at 37 T.C. 461. In his opening brief the Commissioner states: "No exception is taken to the detailed basic findings of the Tax Court."

In the same brief the Commissioner summarizes
341 what he contends are the essentials of the transaction. We quote the summary, but with additions, in brackets, from the record:

> "Taxpayers, consisting of Clay Brown, his wife and three children, and the two Booths, owned substantially all of the stock of Clay Brown & Company, which had lumber interests and saw mills near Fortuna, California. Although the total cost basis of

their investment was only $42,000, the accumulated surplus of the corporation at January 31, 1953 was $448,472, and prospects of future earnings were good.

In the summer of 1952, Clay Brown, the president of the corporation and spokesman for the other stockholders, was approached by a representative of the Institute, a tax-exempt corporation, who supplied him with brochures describing the tax advantages of a particular type of 'sale' transaction. [There was considerable bargaining, at arms length, and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets.] When, as it happened, taxpayers agreed to the plan, a complex set of interrelated legal documents was drafted to give it effect. Pursuant to the overall plan agreed upon in advance, the following steps were taken:

(a) Taxpayers endorsed and delivered all of their shares in the corporation to the Institute, together with $125,000 face amount of promissory notes of the corporation held by Clay Brown and his wife. On the same day, February 4, 1953, the Institute delivered to taxpayers its promissory note in the face amount of $1,300,000. The note, which was to mature approximately 10 years later, was nonnegotiable and noninterest bearing. The Institute assumed no liability for payment of the note from its own assets. Payment of the purchase price was to be made solely out of amounts received by the Institute as 'rental' income of the business assets, of which 90 percent would be turned over to taxpayer as periodic installments.

(b) The Institute was [illegible] no option as to the disposition of the property, which was provided for in predrafted instruments. The following steps were
342 taken pursuant to the plan: (1) The corporation was dissolved; (2) $5,000 of the current assets was turned over to taxpayers as a down payment; (3) the remaining net current assets were 'sold' for another promissory note to a new corporation, Fortuna Mills, Inc., organized by taxpayer Clay Brown's attorneys for the specific purpose of taking over the business

of the dissolved corporation; [All of the issued stock of Fortuna was purchased by the attorneys, with their own funds, for $25,000.] (4) all of the other assets were mortgaged back to taxpayers, permitting reacquisition of [that portion of] the business assets in the event of default on the installments on the purchase price; (5) the same assets were 'rented' by the Institute to Fortuna for 80 per cent of the net profits of the business, without allowance for taxes or depreciation. The Institute retaining 10 per cent of this amount, was obligated to turn over the balance to taxpayers to be applied toward the purchase price.

(e) As part of the plan, taxpayer Clay Brown was employed as 'general manager' of Fortuna at an annual salary of $25,000, and it was provided that if he ceased to act as general manager, his successor would be selected by taxpayers. He exercised substantially the same powers as those which he had as president of the dissolved corporation, and no property could be sold without his consent. Moreover, Brown personally guaranteed mortgage loans of the old company transferred to Fortuna, and he also personally guaranteed another $50,000 loan to Fortuna, which had been capitalized at only $25,000.

The new Fortuna corporation took over the operation of the business, which continued for 4½ years on the same premises, with the same operating personnel and under practical control of taxpayers. On June 19, 1957, after suffering business reverses, Fortuna shut down the mill on word from Clay Brown. Taxpayers did not exercise their option to declare a default and formally reacquire their property by foreclosure. Instead, they arranged for the Institute to sell the assets, retaining 10 percent of the proceeds. The assets, which had been appraised prior to the original 'sale'
343 to the Institute at more than $1,000,000 were sold at only $300,000, to outsiders at sometime in July, 1959. Taxpayer received 90 percent of the proceeds. Steps were taken at that time to settle out and cancel all of the tricornered arrangements between Fortuna, the Institute and taxpayers. The net financial result of

the plan was that taxpayers received a total of $936,131.85."

We think we should add to this summary certain additional findings and conclusions of the Tax Court which are:

1. That there was a change of economic benefits in the transaction.

2. That the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research.

In the court below the Commissioner took two alternative positions: One was that the transaction was a sham. This position is abandoned here. The other, which the Commissioner also takes before us, was that the Tax Court erred in holding that there was a sale within the meaning of section 117(a) of the Internal Revenue Code of 1939 and section 1222(3) of the Internal Revenue Code of 1954 because, so the Commissioner says, certain normal aspects of the sale of a business were missing. These are (1) shift of business risk; (2) shift of benefit of income; (3) shift of operational control; (4) permanent shift of ownership of assets and (5) release of sellers from business indebtedness. The Commissioner relies upon *Burnet* v. *Harmel*, 1932, 287 U.S. 103 as to shift of business risk, upon *Helvering* v. *Clifford*, 1940, 309 U.S. 331 as to shift of benefit of income, and on *Commissioner* v. *Sunnen*, 1948, 333 U.S. 591 as to shift of operational control.

We think that the Commissioner's contentions are well answered in the opinion of the Tax Court, and also in the following cases: *Commissioner* v. *Johnson*, 1 Cir., 1959, 267 F.2d 382; *Union Bank* v. *United States*, Ct.Cl., 1961, 285 F.2d 126.

Here, as in those cases, there was a transfer of title;
there was a shift of business risk in the sense that
344 the operation of the business was in the hands of a
new company owned by third persons, albeit managed under a contract by one of the taxpayers; there was a shift of benefit of income in the sense that Fortuna retained 20% of it and the Institute retained 10% of 80%;

there was no understanding that the assets were to come back to the taxpayers under any circumstances other than a default in the payment of the purchase price; there was a permanent shift of ownership of assets. The management contract and the guarantee of certain of Fortuna's borrowings by one of the taxpayers (Clay Brown), were designed to secure the payment of the price. There was no understanding that, if the business should be unsuccessful, Brown would take action to "trigger" a default, thus causing a reversion of the mortgaged assets to the taxpayers. As was said by the court in *Commissioner* v. *Johnson, supra,* "The mere fact that the security holders may in the future have to resume proprietorship of the enterprise does not nullify the fact that they had sold those proprietary interests." (267 F.2d at 385)

The Commissioner relies also on *Kolkey* v. *Commissioner,* 7 Cir., 1958, 254 F. 2d 51. This case was distinguished in *Commissioner* v. *Johnson, supra,* on the ground that in *Kolkey* the facts were different and the Tax Court had found, in substance in that case, that there was no sale. The Tax Court made the same distinction here, and we think it was correct. We think that the real holding in *Kolkey* was that the transaction was a sham. Here, the finding is the other way and the evidence sustains it.

There is no question that this transaction took the form that it did because the Institute is a tax-exempt corporation and that the price to be paid was probably greater for that reason. These facts may have some relevance in connection with possible tax liabilities of the Institute, but they do not, as a matter of law, establish that, so far as the taxpayers were concerned, the sale of their stock was not a genuine sale, which is the only issue involved in this case.

We think that it is of some significance that the problem of misuse by tax-exempt organizations of their tax exemption in transactions similar to this was considered by the Congress, which adopted certain remedial legislation
345 in the Revenue Act of 1950. The history of this legislation appears in H.R.Rep. No. 2319, 81st Cong. 2d Sess., 1950-2, Cum. Bull. 330, 408-11, and in S. Rep. No. 2375, 81st Cong. 2d Sess., 1950-2, Cum. Bull. 483, 502 ff. Certain aspects of the transaction now before us were un-

doubtedly "tailored" to fit the law as amended by Congress in 1950 particularly section 101 of the Revenue Act of 1939 as amended, and sections 421, 422, and 423. These sections all relate to the income and tax exempt status of the purchasing Institute; none of them purports to deny to the sellers the right to treat the sale, for tax purposes, as a sale, and therefore to treat moneys received as capital gains. Congress could have dealt with that aspect of such transactions but did not do so. If, as is indicated by the writers of the articles cited at the beginning of this opinion, the present situation, insofar as the tax position of the sellers is concerned, is undesirable from a tax standpoint, it is still possible for Congress to provide a remedy.

Affirmed.

(File endorsement omitted)

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346 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18228

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CLAY B. BROWN, et al., *Respondent*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

347 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18229

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

DONALD L. BROWN and INGRID R. BROWN, *Respondents*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

348 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18230

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CHARLES WILLIAM BOOTH and NANCY H. BOOTH, *Respondents*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

349 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18231

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,
v.
DONALD LEE BROWN, *Respondent*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

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350 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18232

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,
v.
PHILLIP F. BROWN, *Respondent*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

351 IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 18233

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

MARILYN BROWN, *Respondent*.

Judgment—December 10, 1963

Upon Petition to Review a Decision of The Tax Court of the United States, ...

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, ... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ..... Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered December 10, 1963

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352 (Clerk's Certificate to foregoing transcript omitted in printing)

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353 SUPREME COURT OF THE UNITED STATES

No. ....., October Term, 1963

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CLAY B. BROWN, et al.

Order Extending Time to File Petition for Writ of Certiorari
April 3, 1964

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, further extended to and including April 24, 1964.

WM. O. DOUGLAS
Associate Justice of the Supreme Court of the United States.

Dated this 3rd day of April, 1964

No. 1041, October Term, 1963

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,

v.

CLAY B. BROWN, et al.

Order Allowing Certiorari—June 8, 1964

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the Tax Court (R. 17–81)[1] is reported at 37 T.C. 461. The opinion of the court of appeals (App. 37–43) is reported at 325 F. 2d 313.

[1] "R." refers to the Transcript of Record printed for use in the court of appeals; "App.", to the appendix to this petition.

JURISDICTION

The judgments of the court of appeals were entered on December 10, 1963 (App. 44). By orders dated March 11, 1964, and April 3, 1964, Mr. Justice Douglas extended the time for filing a petition for certiorari to April 24, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a purported sale of a business to a charity in which the charity makes no down payment, pledges no assets, assumes no personal liability, and provides no managerial services, with the "purchase price" being payable solely out of the income of the business and with the "seller" having recourse, in the event of default, solely against the assets of the business, constitutes a "sale" of the business within the meaning of § 1222(3) of the Internal Revenue Code of 1954 (and § 117(a)(4) of the 1939 Code), thereby entitling the "seller" to report his subsequent receipts of the earnings of the business as capital gains rather than as ordinary income.

STATUTE INVOLVED

Section 1222(3) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.) [1] provides that:

> The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

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[1] § 117(a)(4) of the 1939 Code (26 U.S.C., 1952 ed.) is identical.

STATEMENT

The facts are set forth in detail in the findings of the Tax Court (R. 18–57). For present purposes, an abbreviated statement will suffice.

1. Respondents are the former stockholders of Clay Brown & Company, a corporation engaged in lumber milling. Respondent Clay B. Brown was president of the company and, with his wife and children, owned 94% of the stock. The balance was owned by two other officers of the company[1] (R. 21).

In February 1953, pursuant to a pre-arranged plan, the following occurred: Respondents conveyed their stock[2] to the West Los Angeles Institute for Cancer Research. The Institute liquidated the corporation, paid respondents $5,000 from the proceeds as a down payment, and then "leased" the remaining assets[3] to Fortuna Mills, Inc., a newly-formed corporation owned by respondents' attorneys. Under the terms of the "lease," Fortuna was to operate the mill and pay over to the Institute, as "rent," 80% of the net profits before taxes or depreciation. The lease was for a five-year term and required Fortuna

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[1] One of the officers, C. A. Hill, owning about 1.5% of the stock, is not a party to these proceedings but for convenience we will refer to respondents as including all of the stockholders.

[2] Notes against the corporation in the amount of $125,000, held by Clay Brown and his wife, were also conveyed and cancelled as part of the transaction, but for simplicity we will treat the conveyance as being solely of stock.

[3] Except for the current assets, which were sold to the lessee in exchange for its assumption of the corporate debts and its note for the excess of the current assets over the liabilities assumed (approximately $21,000) (R. 42–43).

to employ Clay Brown as general manager for the period of the lease. In exchange for the stock, the Institute gave respondents a nonnegotiable, noninterest-bearing, note in the amount of $1,300,000, maturing in ten years and secured by a mortgage on the assets of the liquidated corporation.* The Institute was not personally liable on the note. The limit of its obligation was to make payments equal to 90% of whatever "rents" it received from Fortuna. If the payments fell below $250,000 in any two-year period, respondents were entitled to declare the entire balance due and, upon default, to foreclose (R. 37–44). In brief, respondents conveyed their stock to the Institute in exchange for a right to 72% (90% of 80%) of the net profits of the business until they had received $1,300,000.

The negotiations looking to the transaction had been initiated by the Institute, which provided respondents with brochures describing the advantages to the owners of a business of such a "sale," among them being that they could sell the business for more than they could for cash, continue to control the business operations and draw their regular salaries, and yet pay only a capital-gain tax on the proceeds (R. 23–25). The Institute had no prior relationship to respondents; the purchase price was arrived at through arm's-length negotiations; and the Institute's only reason for entering into the transaction was the anticipated financial gain to itself (*i.e.*, the receipt

*The note the Institute received from Fortuna for the current assets (see note 5, *supra*) was also assigned to respondents as security.

of 10% of the "rents" during the period of payment and the prospect of owning the business outright after payment was completed) (R. 36, 57).

2. Simultaneously with the above transactions, Fortuna employed respondent Clay Brown as general manager at his former salary ($25,000), and the business continued in operation, without interruption, on the same premises and with the same personnel (R. 44, 47).[7] During the years 1953–1956, the Institute paid over to respondents a total of $651,094 out of the "rents" it received from Fortuna (R. 56). Beginning in November 1956, the mill suffered heavy losses as a result of a decline in lumber prices, and in June 1957 the mill was shut down (R. 50). Pursuant to a further agreement of the parties (entered into in lieu of foreclosure), the Institute sold the properties to third parties in 1958 for $300,000, retained 10% of the proceeds, and paid the balance ($262,096, after costs of sale) over to respondents in settlement of all obligations (R. 54–55).[8]

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[7] As required by the lease, Clay Brown was originally employed for a five-year term (R. 30). In November 1954, however, Clay Brown's attorney advised him of a recent revenue ruling involving a similar transaction and recommended that, among other things, the requirement of a management contract be eliminated (R. 49). Clay Brown then resigned as general manager, effective October 31, 1954, and waived his rights under the lease to approve his successor. He continued to be retained (at a salary of $12,000) in an advisory capacity with the authority to sign corporate checks, but he was succeeded as general manager by respondent Booth (R. 48, 123, 125–126).

[8] Respondents also received $20,849 from Fortuna in payment of its assigned note for the current assets (see notes 5 and 6, *supra;* R. 51, 56).

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3. Only the taxable years 1953–1956 (*i.e.*, prior to the default) are involved in this case. Using the installment method, each respondent reported his gains for each year as long-term capital gain. The Commissioner of Internal Revenue held that the transaction was not a "sale" within the meaning of § 1222(3) of the Internal Revenue Code of 1954[9] and that the gains were taxable as ordinary income, determining deficiencies accordingly (R. 57).

The full Tax Court (R. 57–72), with six judges dissenting (R. 72–81), held the transaction a "sale" and the gains taxable only as capital gains. The court noted that "It may be * * * that [respondents] would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," but said that a taxpayer has the right "to increase the amount received from a transaction over what he might have received from a different transaction" and that a sale is not to be ignored "solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay" (R. 62).[10]

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[9] The first year involved is governed by the 1939 Code, § 117 (a)(4) of which is identical, but for convenience all section references in this petition will, unless otherwise indicated, be to the 1954 Code.

[10] The price was, moreover, a "result of real negotiating" and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth" (R. 64), confirming that the Institute acted at arm's-length with a real expectation that the earnings would be sufficient to permit full payment and that there was no "tacit understanding" that the transaction would collapse, permitting respondents to recover possession (R. 63–64, 36).

The court of appeals affirmed (App. 37–43). Although acknowledging that the transaction took the form it did because the Institute was tax-exempt and that "the price to be paid was probably greater for that reason" (App. 42), it held that the transaction was a "genuine sale" because there was a transfer of title, of permanent ownership, of the benefit of part of the current income, and of the operation of the business (App. 41–42).

REASONS FOR GRANTING THE WRIT

This is a tax case of rare importance. Its importance lies both in the fundamental character of the question of statutory interpretation involved—what constitutes a "sale" for purposes of the capital-gains provisions—and in the social, economic, and revenue implications of the particular transaction in issue—"bootstrap" sales of businesses to charities.

The character of the transaction in this case is obscured by its complexity, which in turn is attributable to the effort to combine the advantages of the "bootstrap" technique with those flowing from the Institute's tax exemption. In order to separate the elements of the transaction, we will consider first a simpler form of "bootstrap" sale to a non-exempt purchaser and show the nature and importance of the questions such as transaction presents. We will then show how that device has been exploited, and its advantages magnified, in sales, as here, to charitable foundations.

I.

A "bootstrap" sale—so called because the business in effect buys itself—is one in which the "buyer"

makes no down payment,[11] pledges no assets, assumes no meaningful personal liability, and provides no managerial services. As a consequence, the "seller" can look only to the income and assets of the very business transferred for payment of the "purchase price." Since an owner is entitled to *all* the income and assets of the business, a transaction in which he limits his claims against it to a stated maximum amount (the "purchase price"), receiving nothing from the "buyer" and continuing to bear all the risks of the business, makes no economic sense. As we will demonstrate, it is but an elaborate device for the attempted conversion of ordinary business earnings into capital gains.

1. Suppose that *A* owns all the stock of a corporation, *X*, currently producing $100,000 a year in after-tax income. The business is relatively speculative, and the most that *A* could receive for his stock in cash (or from a solvent purchaser who would make a substantial down payment) is $500,000. *B*, however, proposes to buy the stock on the following terms: *B* will create corporation *Y* with a paid-in capital of $100; *A* will transfer his *X* stock to *Y*; *Y* will liquidate *X*, take over its assets, and employ *A* to continue to manage the business; and *Y* will give *A* its corporate notes, payable $100,000 a year and secured by a mortgage on the acquired assets, in whatever total face amount the parties agree upon as the "purchase price" for *A*'s stock. In short, *A* is to sell his half-

[11] *I.e.*, other than, as here, out of the very assets transferred.

million-dollar business to *B*'s penniless corporation solely for the notes of that corporation, the purest and simplest form of a bootstrap sale.

Assuming that *A* and *B* are wholly unrelated and that there is no desire to make a gift, the "price" they agree upon will necessarily be greater than $500,000: with no equity or "cushion" to secure their payment, notes from *Y* for $500,000 would be worth considerably less than their face value,[12] and at that price *A* could have gotten cash or adequate security and been relieved of any further risk, whereas in the proposed transaction he is to continue to bear the full risk of loss. On the other hand, neither economics nor fairness imposes an upper limit on the price. *A*, who begins with everything and is to continue even to manage the business, is entitled to the fruits of the business without limit so long as he is to receive nothing else. *B*, who is to put up nothing and to assume no obligations, is entitled to nothing and has no complaint to make to any price. There is nothing

[12] That would be so even if, as is not the case here, the notes bore interest, for the simple truth is that no amount of notes against a corporation, with or without interest, can ever be worth quite so much as full ownership of its assets, which is what *A* is to give up. The absence of stated interest, however, makes even more blatant the attempted conversion of ordinary income into capital gain (see note 14, *infra*). We do not emphasize that aspect of the case here, not because we do not believe it is an important element, but because it is only a part of the story, and the rest of the story is what differentiates bootstrap sales from various other transactions in which interest is also disguised.

to bargain about, and however high the price is set—say, $5 million payable $100,000 a year for 50 years—it will still be less than a "reasonable" one and *A* will still be surrendering the ultimate ownership of the business to *B* for nothing.

There being no economic determinants of the price, the upward limit can be determined only by tax considerations. To make the transaction look like a "sale," there must, of course, be a "price" of some sort, and the tax commentators uniformly advise that it not be set too high lest the device be made transparent.[12] The optimum price will be that at which the tax gains, discounted by the tax risks, will exceed the economic loss by the maximum amount. Thus, while a price 10 or 20 times the value of the business would make as much (indeed, more) economic sense, *A* would presumably seek to lessen the tax risks by settling for a more modest figure—in the range, say, of $1 million to $2 million.

The tax gains from such a transaction, treated as a "sale," are apparent, for the earnings of the business paid over to *A* during the period of the pay-out will be taxed only as capital gains rather than as

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[12] See Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87 (1956); MacCracken, *Selling a Business to a Charitable Foundation*, 1954 U. of So. Calif. Tax Inst. 205; Comment, *The Three-Party Sale and Lease-Back*, 61 Mich. L. Rev. 1140 (1963); Alexander, *The Use of Foundations in Business*, 15 N.Y.U. Tax Inst. 591; *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963). For commentaries critical of the judicial treatment of such transactions, see Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. of Pa. L. Rev. 623 (1960); Moore and Dohan, *supra*.

ordinary income (as they would have been if received as dividends). The difference in the tax rates will, in turn, more than compensate for the economic loss (*i.e.*, the sacrifice of the residual interest). The net gain can be illustrated by making the neutral assumption that the after-tax earnings ($100,000) and cash value ($500,000) of the business remain constant throughout the period of the pay-out and by comparing the after-tax results with the results had *A* retained his stock, and received the earnings as dividends, for the same period and then sold the business for its cash value. We will assume that *A*'s basis for the stock (often, as here, quite low) is zero and that he is in an 80% tax bracket.

In a bootstrap sale for $2 million, *A* would receive only the annual payments of $100,000 for 20 years and then have no further interest in the business. His $2 million receipts, however, would be taxed only at the maximum capital-gains rate of 25% and he would have $1,500,000 left after taxes. If he retained the business for 20 years and then sold it, he would receive not only its 20-year earnings of $2 million but also an additional $500,000 on its sale at the end of that time. In that event, however, his $2 million in annual receipts would be taxable as dividends at an 80% rate, leaving him with only $400,000, which together with his $375,000 in after-tax receipts from the cash sale of the business ($500,000 taxable as capital gains) would give him a total of only $775,000. The after-tax proceeds of a $2 million bootstrap sale are thus almost double ($1,500,000) those of a reten-

tion and cash sale ($775,000).[14] On the same comparison, a bootstrap sale at the more modest price of $1 million (10-year pay-out) is still highly profitable, yielding $750,000 after taxes as compared with $575,000 for a retention and cash sale.[15]

2. Although such a transaction makes no economic sense and can be explained only by the hoped-for tax benefits, we do not deny that it has "substance", is "real" and not a "sham", and may result ultimately in a transfer of full ownership. Whether the "substance" of the transaction is that of a "sale," however, depends on what the "substance" of a "sale" is—*i.e.*, on the meaning of that word as used in the statute. It is that question of statutory interpreta-

[14] Another revealing comparison is to a bootstrap sale with interest on the deferred payments. A sale at $1,300,000 with 4½% interest would produce the same total payments ($100,000 a year for 20 years), but $700,000 of *A*'s $2 million receipts would then be taxable as interest income at an 80% rate ($140,000 after taxes) and only $1,300,000 would receive capital-gains treatment ($975,000 after taxes), producing total after-tax receipts of only $1,115,000. A sale at $1,147,000 with 6% interest would yield the same payments but only $1,030,850 after taxes. As those examples show, the disguising of the interest element—*i.e.*, stating the price as $2 million without interest rather than as $1.3 million with 4½% interest—accounts for a substantial part (though by no means all) of the tax benefits. In bootstrap sales to exempt purchasers, as we will show (see pp. 24–25, *infra*), a much more rapid pay-out is possible, with the result that the disguising of the interest element accounts for relatively less (and the "bootstrap" element, relatively more) of the overall tax advantage.

[15] In sales to exempt purchasers, the relative advantages are considerably greater, so the price may be set even lower and still yield a profit. See note 8, *infra*.

tion, so fundamental to the application of the capital-gains provisions, that this case presents.

In our view the essential characteristic of a "sale" is a realization upon the present value of an asset by its conversion into other property, with the consequence that the seller abandons his interest in the future income from the asset and, concomitantly, insulates himself from the risk of future losses. Its essence is a present realization upon the values that have accrued in the past and a termination of the seller's interest in the future—a "cashing in" on the present value of the asset and a shifting of the benefits and burdens of future gains and losses to others. A "sale", in short, is a relinquishment of the future for the present, and no transaction which does not possess that characteristic in some substantial degree is, we submit, entitled to capital gains treatment.

An expression in such general terms of the basic "idea" of a sale does not, to be sure, provide a mechanical definition that may be easily applied to all possible cases. Questions of degree calling for an exercise of judgment will always remain,[16] but judgment cannot be exercised in a vacuum, and before a court

[16] Most obvious, of course, is the question of "how much" of a down payment or credit cushion is necessary to cause a sufficient shifting of the risk to justify "sale" treatment, a question requiring an appraisal, for example, of such imprecise factors as the stable or speculative nature of the business. Another important variable is whether the "buyer" is to manage the business, for the provision of management skills is itself an investment put at risk by the "buyer" which gives the "seller" something different than he had before.

can say whether a particular transaction is a "sale" it must first have some notion, however unmathematically expressed, of what a "sale" is. And there are many cases—including, as we will show, this one—in which even so general a formulation will provide a ready answer.

The restriction of "sales" to cashing-in, risk-shifting, interest-terminating transactions is required by the basic purpose of the capital-gains provisions, which, as this Court has repeatedly recognized, was to afford relief from the application of the steeply progressive ordinary rates to the realization in a single year of values that may have accrued over many years in the past. See, *e.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265; *Burnet* v. *Harmel*, 287 U.S. 103. That purpose obviously does not warrant extending capital-gains treatment to annual receipts derived from a *continuation* of risk-bearing and dependent entirely upon the earnings of the business.

Even more pointed for present purposes are the decisions of this Court in the natural-resources field, establishing that a transaction in which the purported "seller" retains an "economic interest" in the property does not qualify as a "sale." While an outright sale of mineral interests by a landowner qualifies for capital gains treatment, a purported sale of the mineral interests in exchange for a royalty from the minerals produced is treated only as a lease and the royalty payments are fully taxable as ordinary income (*Burnet* v. *Harmel*, 287 U.S. 103) and eligible for the depletion

allowance (*Palmer* v. *Bender*, 287 U.S. 551)." Most closely analogous is a "sale" of the minerals for a nominally fixed price, but with the "price" being payable only out of production (*e.g.*, a "sale" of all the minerals in place for $1 million payable out of ⅝ of the first production). Because such an "oil production payment" is payable only if and when oil is produced, the seller is held to have retained an "economic interest" in the future production and hence not to have made a "sale" of the property, notwithstanding that the transaction is effective to convey title as a matter of state law and that, once the pay-out is completed, full ownership of the minerals will vest in the "purchaser." *Thomas* v. *Perkins*, 301 U.S. 655." What we contend

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[17] While the character of the transferor's receipts and his right to depletion deductions are closely related, the questions are not necessarily coterminous. In two of the earlier depletion cases, the Court seemingly viewed depletion as depending upon having an interest in the minerals in kind and denied depletion to a transferor who received simply a "personal covenant" of the transferee to pay over a share of the "net profits" from the operation of the properties. *Helvering* v. *O'Donnell*, 303 U.S. 370; *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372. The continued vitality of those decisions is questionable in view of the later decisions in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (see also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308), and they were in any event peculiarly concerned with the depletion question.

[18] See also *Palmer* v. *Bender*, 287 U.S. 551. Compare *Anderson* v. *Helvering*, 310 U.S. 404, where there was a down payment of almost one-third of the price and the balance, with 6% interest, was payable either out of production or from a sale of the properties. Because the payment was not dependent solely upon production and the property itself furnished security (en-

for here is neither more nor less than the "economic interest" doctrine which this Court has applied to purported "sales" of minerals but which the lower courts have unaccountably refused to apply to "sales" of businesses."[19]

The characteristics essential to a "sale" are, of course, unmistakably present in a transfer of property in exchange for immediate and full payment in cash or other property. They are also present in—are, indeed, the essence of—a credit sale in which the buyer

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hanced, it should be noted, by the substantial down payment), the Court, distinguishing *Perkins* on that ground, held the transaction to be a sale.

[19] Our brief discussion of the merits, necessary to show the basic nature of the question presented, does not of course begin to exhaust the support that may be marshalled for the concept of a "sale" as a risk-shifting, interest-terminating transaction. The "reorganization" provisions, for example, reflect a Congressional recognition that a transaction in which the transferor's investment remains "at risk" in substantially the same business should not be treated as a "sale or exchange"; and in distinguishing "sales" from "reorganizations" the courts have applied essentially the same criteria we urge here. Whether or not the transaction here could be technically characterized as a "reorganization"—which is at least arguable—the reorganization cases provide compelling analogies. The old cases distinguishing between liquidating distributions and dividends similarly turned upon the extent to which there was a "cut-off" of the stockholder's interest in the future exploitation of the assets and a realization instead upon their present value. Compare *Lynch* v. *Turrish*, 247 U.S. 221, with *Lynch* v. *Hornby*, 247 U.S. 339. The "thin capitalization" cases, which look to the adequacy of the credit cushion and the degree of risk borne by the noteholders to determine whether the notes should be treated as debt or equity interests, are even closer in point and may, indeed, be directly applicable to this case. A fuller development of those analogies must, however, await a brief on the merits.

either makes a substantial down payment, pledges other assets as security, assumes a meaningful personal liability (*i.e.*, of a solvent entity), or provides some other form of guaranty. The down payment or right of recourse against other persons or assets gives the seller a "cushion" to assure payment of the price regardless of the fortunes of the business and thus shifts the primary risk of business success or failure to the buyer. Bearing the risk of future losses, the buyer will insist upon the correlative benefits and will agree to pay only the present value of the business, retaining to himself the benefit of future earnings. By such a transaction, therefore, the seller gives up his interest in the future and settles for a realization of the already-accrued values. And because the buyer's obligation to pay the price has an existence and value independent of the future of the business, there is a meaningful "exchange" of the business for "other property"—a "conversion" of the seller's interest into something else.

Those characteristics are, in contrast, wholly lacking in the bootstrap transaction described above. Since *B* ventures nothing—neither assets, personal liability, nor management—the sole investment is *A*'s and *A* must continue to bear the full risk of future losses or capital depreciation. It is solely on *A*'s investment—whether identified by source or risk-bearing—that the future income of the business is earned. The price is not determined by economic forces and is necessarily greater than the cash value of the busi-

ness," so that its ultimate payment depends not merely upon the avoidance of future losses but upon the realization of future income. Thus *A*, far from opting for the present and leaving the future to others, has chosen instead to leave his investment at risk in the business in the hope that its future earnings will be sufficient to pay him a correspondingly greater amount. And since *Y*, the nominal "buyer," has no assets other than the business transferred by *A*, its "obligation" to pay the "purchase price" has no worth (or, indeed, meaningful existence) independent of the business, and there is, therefore, no "exchange" at all. *A* has simply imposed a limit on his previously unlimited rights to the assets and income of the business and given away for nothing the right to the residue after the "pay-out" of the prescribed amount. If our interpretation of the statute be correct, such a transaction is not a "sale."

3. The broad importance of the question, and the need for its resolution by this Court, is evident. As the Court is aware, a very large portion of all tax controversies involve claims to capital-gains treatment. The Code (§ 1222(3)) defines capital gains simply as gains from the "sale or exchange" of a "capital asset" (in turn defined, but for some specific exclusions, simply as "property," § 1221), and entitlement to the preferential treatment accorded such gains thus turns upon two fundamental questions of

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[*] Unless the transaction is donatively motivated, in which event it would amount to an assignment of the income earned at *A*'s risk on *A*'s investment.

definition: "What is a capital asset?" and "What is a sale?" Despite the generality of the statutory standard and the correspondingly broad responsibility for judicial interpretation, many of the lower courts have resorted to formalism in answering those questions, holding in effect (1) that, since a "capital asset" is defined simply as "property," any interest that is recognized as "property" by state law is *ipso facto* a "capital asset," and (2) that, since "sale" is undefined by the statute, any transaction that is treated as a "sale" by state law (*i.e.*, is effective to pass title) is *ipso facto* a "sale" for capital-gains purposes. This Court, in sharp contrast, has consistently looked to the underlying purposes of the statute and the economic substance of the transaction to determine whether capital-gains treatment is warranted. Its recent decisions, however, have directly involved only the "capital asset" question,[21] and its earlier decisions on the "sale" question, primarily in the natural-resources field, have unaccountably been ignored as often as they have been followed. As a consequence, there exists in the lower courts widespread conflict and confusion on the question, and the need for a restatement of basic principles by this Court has become urgent.

Transactions substantially identical to that involved here (*i.e.*, bootstrap sales to charities) have been held to be "sales", on equally formalistic grounds, by the

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[21] *E.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Corn Products Co.* v. *Commissioner*, 350 U.S. 46.

First Circuit and the Court of Claims.[11] In contrast, the Seventh Circuit, looking instead to the former owners' retention of the economic risks and benefits of the business, held such a transaction not to be a "sale." *Kolkey* v. *Commissioner*, 254 F. 2d 51. It is true that the transaction in that case was made particularly transparent by a "purchase price" many times the current value of the business and by the fact that the fortunes of the highly speculative business declined sharply soon after the transaction, precipitating a default and a reacquisition of the business by the "sellers." Because of those differences, the court below distinguished that transaction from the "genuine sale" in this case on the ground that "We think that the real holding in *Kolkey* was that the transaction was a sham" (App. 42). But that was not the rationale of the *Kolkey* opinion, and in every bootstrap sale the "purchase price" is necessarily wholly arbitrary—being determined only by tax considerations—and its payment entirely dependent on the continued good fortunes of the business. Despite the factual distinctions, therefore, there is, we submit, a basic conflict of principle between the decision below and that of the Seventh Circuit in *Kolkey*.

The divergencies and confusion are not confined to the particular type of transaction in issue here. In what seems to us perhaps the clearest departure by the lower courts from the "economic interest" prin-

[11] *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1); *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cls.); *Knapp Brothers Shoe Mfg. Corp.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.).

ciple established by this Court's decisions, several courts of appeals have held that a transfer of a patent in exchange for a royalty based on the transferee's future sales of the patented item constitutes a "sale" of the patent and that the royalties received over the life of the patent are taxable only as capital gains.[23] The Second Circuit, however, rejects the "sale" characterization and holds the proceeds of the patentee's retained interest in the successful exploitation of the patent to be taxable as ordinary income.[24] That conflict has been resolved by statute as to certain patent transfers[25] but remains viable as to some of the most common, among them transfers to a controlled corporation, probably the class with the most important tax implications.[26] A similar conflict exists as to pur-

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[23] *Commissioner* v. *Celanese Corp.*, 140 F. 2d 339 (C.A.D.C.); *Allen* v. *Werner*, 190 F. 2d 840 (C.A. 5); *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10); *Massey* v. *United States*, 226 F. 2d 724 (C.A. 7); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9); *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); *Kronner* v. *United States*, 110 F. Supp. 730 (Ct. Cls.). It should be noted, however, that in none of those cases was the "economic interest" principle briefed. If the royalty aspect was mentioned at all, it was referred to simply as one of the "factors"—together with, *e.g.*, retained powers of control—which indicated that the particular transfer was "really" a license rather than a sale.

[24] *Bloch* v. *United States*, 200 F. 2d 63 (C.A. 2). The conflict was noted in this Court's recent decision in *United States* v. *Zacks*, 375 U.S. 59, 63 n. 5.

[25] 1954 Code § 1235; 1939 Code § 117(q), added by Act of June 29, 1956, 70 Stat. 404. See *United States* v. *Zacks*, *supra*.

[26] In 1958, faced with a mounting tide of adverse decisions, the Internal Revenue Service finally acquiesced and ceased, for the time being, to litigate the issue. Rev. Rul. 58-353, 58-2 Cum Bull. 408.

ported "sales" of a franchise to use a trade name, with the "seller" retaining a right to royalties based on the franchised dealer's sales,[27] and other examples abound.[28]

A decision characterizing a single transaction cannot, of course, solve all the problems, and we do not ask the Court to do more than decide this case. Yet

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[27] See *Dairy Queen of Oklahoma* v. *Commissioner*, 250 F. 2d 503 (C.A. 10) (both lump sum payment and royalties are capital gain); *Gowdey* v. *Commissioner*, 307 F. 2d 816 (C.A. 4) (only lump sum is capital gain); *Moberg* v. *Commissioner*, 305 F. 2d 800 (C.A. 5) (same); *Moberg* v. *Commissioner*, 310 F. 2d 782 (C.A. 9) (neither lump sum nor royalties capital gain). In these cases, too, the significance of the royalty as *per se* a retained economic interest has been obscured by a reliance also on other factors.

[28] A transfer of land to a cemetery association in exchange for a percentage of its receipts from the resale of the land as burial lots has, for example, been held not to give the transferor an interest in the "income" of the association (*Commissioner* v. *Kensico Cemetery*, 96 F. 2d 594 (C.A. 2); *Forest Lawn Memorial Park* v. *Commissioner*, 45 B.T.A. 1091; but cf. *Sherwood Memorial Gardens, Inc.* v. *Commissioner*, 42 T.C. No. 12, decided April 17, 1964), while, to go to the other extreme, a transfer of property to a trust in exchange for the trust's payment of the gift taxes on the transfer (an obligation in a fixed amount, necessarily equal to only a fraction of the value of the property and thus more than adequately secured) has been held to be a retention of an "income" interest. *Sheaffer* v. *Commissioner*, 313 F. 2d 738 (C.A. 8), certiorari denied, 375 U.S. 818. Even in the natural-resources field, where this Court's earlier decisions, having dealt with the same subject matter, seem to have had more impact, there are sharp divergencies in the treatment of purported "sales" of sand and gravel deposits for a royalty based on the amount of production. Compare *Crowell Land & Mineral Corp.* v. *Commissioner*, 242 F. 2d 864 (C.A. 5), and *Linehan* v. *Commissioner*, 297 F. 2d 276 (C.A. 1), with *Laudenslager* v. *Commissioner*, 305 F. 2d 686 (C.A. 3), certiorari denied, 371 U.S. 947.

there now exists among the lower courts no core of agreement even as to the most generalized concept of what a "sale" is. A decision of this case, while not providing a blueprint for all subsequent cases, would at least negate some of the misconceptions and refocus attention on the relevant factors. The problem is pervasive, and the task, one that only this Court can perform.[29]

[29] It should be noted that a decision that such a transaction does not qualify as a "sale" would not automatically determine the proper tax treatment of the receipts from the retained interest. Such a transaction does have "substance"—primarily a shift of the residual interest but also an intervention of new legal entities—and does effect a real change in the nature of the former owner's interest. There would remain a question, therefore, how the retained interest should be classified and how the proceeds from it should be accounted for: as dividends (treating *A*'s notes in *Y* as "stock"); as proceeds from a joint venture (treating *A* and *Y* as "partners," with *A* providing the assets and *Y* the management); as income distributions on a trust analogy (treating the transaction essentially as a gift in trust with a retained income interest); simply as "gains" not otherwise provided for, taxable as income under § 61(a); etc. Those questions—which may, among other things, turn on the particular form the transaction takes—need not be explored here, however, and even if the case is heard on the merits the Court may prefer to decide only the basic question whether the transaction is a "sale" and leave to the lower courts on remand, at least initially, the question of the proper alternative characterization of the receipts. For the years involved in this case, moreover, we doubt that any of the possible alternative characterizations would make a difference in result. At least respondents have yet to claim any alternative characterization of their receipts (assuming the transaction is not a "sale") that would justify their treatment as anything other than ordinary income.

II.

While the tax treatment of the "seller" in a bootstrap sale turns on the same basic questions whether the "purhaser" is an exempt or non-exempt entity, it is in transactions with charities that the bootstrap technique has been most extensively exploited. The reason is obvious. At a 52% corporate income tax rate, $100,000 of business income yields only $48,000 after taxes in a taxable corporation but a full $100,000 if the business can be brought under the tax-exemption umbrella of a charitable foundation. In a bootstrap sale to a charity, therefore, the marriage of the charity's exemption with the business' income doubles the cash yield from the business, thereby not only giving the "seller" greater assurance that the "purchase price" can be paid (though payment is still dependent on there *being* income) but also permitting a much more rapid pay-out.[20] The transaction

[20] We do not, it should be noted, suggest that the fact that the buyer is tax-exempt will cause the "purchase price" to be any higher. As we have seen, there is no limit, other than tax caution, to the price that may be set in a bootstrap sale to a non-exempt buyer. The only difference is that, if the buyer is exempt, any given price may be paid faster and more surely. Indeed, an exempt purchaser has something real to contribute to the transaction—the use of its tax exemption—and thus, to a degree, has something to "bargain" about. If anything, therefore, an exempt buyer might be able to negotiate a somewhat lower "price" than the seller might choose to set, as he would be free to do, in a sale to a non-exempt purchaser. But while the "bargaining" might to that extent be more "real", its content is still entirely different from that of commercial bargaining and the resulting "price" continues to bear no inherent relationship to the present value of the business.

is an even greater boon to the charity. By virtue of its exemption, it is able to attract bootstrap sellers and thereby acquire ultimate ownership of valuable business properties with neither investment nor effort. It is able, in effect, to "capitalize" its tax exemption, using the exemption and nothing else to acquire a valuable business. Rather than simply relieving from tax the income earned on capital originally contributed by charitable benefactors, the tax exemption is transmuted: it becomes the very source of capital. If the bootstrap sale of a business to charity can withstand attack, business entrepreneurs have the magic means of converting ordinary business income into capital gains and charities the key to 100% federal financing of their activities.[21]

[21] The effects of the transaction can be illustrated by returning to our original example of *A*'s corporate business with after-tax earnings of $100,000 (approximately $200,000 before taxes) and a cash value of $500,000. If the business is operated for 10 years and then sold for its cash value, its total cash yield (assuming constant income and values) will be $2,500,000. If *A* retained the business throughout the period, the corporation would pay $1,000,000 in corporate income taxes, and *A* would pay $800,000 in individual income taxes (at 80%) on the remaining $1,000,000 of business income distributed as dividends, plus $125,000 in capital gains taxes on the cash sale. The $2,500,000 yield would thus be distributed $1,925,000 in taxes to the government and $575,000 to *A*. If, instead, *A* made a bootstrap sale of the business to Charity for $2,000,000 payable $200,000 a year for 10 years, and after the pay-out Charity sold the business for $500,000, no corporate income taxes would be paid, *A*'s $2,000,000 receipts would be subject only to a $500,000 capital gains tax, and no tax would be paid on Charity's sale of the business. The $2,500,000 total yield from the business would thus be distributed $500,000 in taxes

1. While Congress has never addressed itself to the tax treatment of bootstrap sellers, it has attempted to prevent the exploitation of the charitable exemption in such transactions. It is that attempt that explains the rather indirect and complicated form of the transaction in this case.

Bootstrap sales to charity were originally cast in a form identical to the transaction described above except that the "buying" corporation (*Y*) would be organized, with a nominal initial contribution, as a "feeder" to some established charity—*i.e.*, its charter would require it ultimately to pay over its income and assets to the "parent" foundation. It is in that form, for example, that a "feeder" for New York University, with an initial capitalization of $1,000, "bought" the Howes Leather Company for $30 million. *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1). For similar transactions, see *Knapp Brothers Shoe Mfg. Corp.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.); *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7); *Ohio Furnace Co.* v. *Commissioner*, 25 T.C. 179; *Truschel* v. *Commissioner*, 29 T.C. 433; *cf. Caldwell* v. *Campbell*, 218 F. 2d 567 (C.A. 5). A somewhat different transaction, also being widely exploited at

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to the government, $1,500,000 to *A*, and $500,000 to Charity. Thus, not only would *A*'s receipts be converted into capital gains, but the $1,000,000 in corporate income taxes "saved" by virtue of the charitable exemption would be divided equally between *A* and Charity. In effect, Charity "buys" the business with its tax exemption, at a cost to the Treasury—*i.e.*, to other taxpayers—of $2 for every $1 Charity ends up with, a result that might better be described as 200% federal financing.

the time, was the "sale and lease-back," in which a business "sold" its real property or equipment to a charity and simultaneously "leased" it back on a long-term lease. The charity would borrow the purchase price from a third party on the security of the property and the lease and then pay off the loan out of its tax-free rentals under the lease (appropriately tailored to the purpose)." Once again, the charity, with no investment of its own, was able to "capitalize" its tax exemption into eventual ownership of the property.

In the Revenue Act of 1950, § 301, 64 Stat. 948, Congress attempted to stop such transactions. It did so by providing that corporations engaged solely in operating a business and paying the income over to another charity ("feeders") would no longer be exempt (now § 502) and that foundations which engaged both in business and in charitable activities would be taxable on their "unrelated business income" (§ 511). While so-called "passive" income in the form of dividends, interest, rents, *etc.*, continued to be exempt, in order to prevent the "lease-back" device it was further provided that rentals under long-term leases (more than five years) of property purchased on credit would also be taxable (§ 514).

In explaining the reason for the "feeder" and "unrelated business income" provisions, the commit-

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" See Cary, *Corporate Financing Through the Sale and Lease-Back of Property*, 62 Harv. L. Rev. 1; Note, *Taxation of Sale and Lease-Back Transactions*, 60 Yale L. J. 879.

tee reports noted the unfair competitive advantage tax-exempt businesses were thought to have and added:[23]

> * * *. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemption to buy an ordinary business. That is, they have acquired the business with no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable.

In explaining the objections to the lease-back device, the committees noted that "the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption," with "the fact that it pays no income tax on the rentals received" being "the only reason why it receives the property at no expense to itself." The fact that a charity "need not use any of its own funds" also meant that "there is no limit to the property an exempt institution may acquire in this manner," creating a threat that "exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country." The committees noted also that a possibility "exists in each case that the exempt organization has in effect sold part of its exemption" by either "paying a higher price for the property or by charging lower rentals than a taxable

[23] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 36–37; S. Rep. 2375, 81st Cong., 2d Sess., pp. 28–29.

business could charge"—a possibility which, although "difficult" to prove, arises from the fact that, since the arrangement "does not require the commitment of any of its own funds," the normal economic restraints are absent.[24]

The transaction in this case, it may be seen, is carefully designed to skirt that remedial legislation. To avoid the "feeder" provision, the stock is sold to the Institute itself, but with its liability being contractually limited to the assets transferred in order to achieve an equivalent insulation of the Institute from the risks of the business. To avoid the "unrelated business income" tax, the business is then "leased" to a newly-formed operating company with the payments, although measured by 80% of the net income of the business before depreciation or taxes, being labelled "rent" and therefore, hopefully, not taxable as "business income." To avoid the tax on rentals from long-term leases of debt-burdened property, the lease is limited to five years, with new arrangements then to be made if the income has not been sufficient by that time to complete the pay-out (see R. 26–27). The transaction, in short, is the same in economic substance as the old direct form of a bootstrap sale to a feeder but has been "gerrymandered" around the 1950 amendments designed to prevent such transactions.

While the bootstrap sale to a charity in its most recent dress may pose new and substantial questions

[24] H. Rep. No. 2319, *supra*, pp. 38–39; S. Rep. No. 2375, *supra*, pp. 31–32.

as to the tax treatment of the purchasing charity,[35] from the seller's point of view the transaction is substantially identical to the earlier form of bootstrap sales to feeders or, for that matter (but for the added advantage of a quicker and surer pay-out), to bootstrap sales to non-exempt purchasers. And it is, of course, only that question—whether the transaction should be treated as a "sale" for purposes of the tax treatment of the owners—that is directly involved here.

2. The increasing exploitation of the bootstrap technique in sales to charities makes urgent the need for review of the basic "sale" question, for that is the predicate upon which the transactions are built. As the extensive discussion of such transactions in the tax literature[36] suggests, the technique has already been widely employed. The decisions reported to date involving such transactions include not only the six cases cited above (p. 26) involving sales to "feeders" but also the following cases involving the "sale and lease" arrangement: *Union Bank* v. *United*

[35] In particular, the labeling of the 80%–20% profit-sharing agreement with the operating company as a "lease" rather than as a "joint venture" or a "management contract" (the operating company being given 20% of the net profits as its fee for managing the business on behalf of the Institute), seems to us a transparent attempt to make tax consequences turn on mere labels and form rather than economic substance. And there remains the old question whether such transactions, resulting in the benefit of the tax exemption accruing in part to the private sellers, do not result in the foundation's being operated for other than "exclusively charitable" purposes, thus causing a complete loss of its exemption.

[36] See note 13, *supra*.

States, 285 F. 2d 126 (Ct. Cls); *Anderson Dairy, Inc.* v. *Commissioner*, 39 T.C. 1027; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Singer* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,158; *Isis Windows, Inc.* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,176; *Brekke* v. *Commissioner*, 40 T.C. 789; *Estate of Hawley* v. *Commissioner*, 1961 P-H T.C. Mem. Dec. ¶ 61,038; cf. *Estate of Hawthorne* v. *Commissioner*, 1960 P-H T.C. Mem. Dec. ¶ 60,146. The first six of those cases all involved transactions with a single foundation (the University Hill Foundation, associated with Loyola University) which, we are advised, has now purchased a total of 26 different businesses, at an average price of $1.3 million each, in transactions substantially identical to that in this case—that is, without the investment of a single dollar of its own funds and using nothing more than its tax exemption. The cases now pending administratively or in court involve an estimated $26 million in taxes (including, in some cases, deficiencies asserted against the foundation or the operating company), and there is good reason to believe that there have been many other bootstrap transactions that have gone unnoticed or unchallenged. Adding to the need for review by this Court without awaiting further developments in the lower courts is the fact that all of the cases now pending in court are within the jurisdiction of the court below[37] and that the Court of Claims, a forum avail-

[37] Petitions for review of the *Anderson Dairy*, *Royal Farms*, *Singer*, and *Isis Windows* cases, *supra*, are already pending in that court and are being held in abeyance to await the final disposition of this case.

able to all taxpayers, has also held such transactions to be "sales." *Union Bank, supra.*

Even more serious are the implications for the future—social and economic as well as fiscal—if the decision below is allowed to stand. In 1950, the Congressional committees described the "lease-back" arrangement as "the most noteworthy financial device of the present century" and one which, because of the unlimited means it afforded charities to acquire property with no investment of their own, could lead to ownership by charities of "the great bulk of the commercial and industrial real estate in the country."[38] The bootstrap transaction now being exploited not only offers the same opportunities to exempt organizations as did the lease-back device—the ability to make unlimited acquisitions of business properties with no investment of their own—but affords far greater tax advantages to the "sellers." If the decision below be the law, there is no reason for any high-bracket owner of a business to continue to pay a dividend tax on its earnings. The success to date of a single foundation (and there are over 50,000 of them) in finding 26 different businesses to buy "for nothing" suggests the likely outcome.[39]

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[38] H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 38, 39; S. Rep. No. 2375, 81st Cong., 2d Sess., p. 31.

[39] Note that the transaction here was initiated by the Institute, that its plan had been prepared by the same attorney who had worked out the sales to the University Hill Foundation, and that, by the time of trial, it had investigated some two dozen business acquisitions and undertaken two (R. 23–24, 36).

The principal deterrent to such transactions thus far has been the fear that the tax treatment on which they depend might be successfully challenged. With the Ninth Circuit now having joined the First Circuit and the Court of Claims in upholding the "sale" treatment of such transactions (and with the Seventh Circuit's contrary decision in *Kolkey* explained away as merely a warning to taxpayers to be somewhat more discreet in setting the terms), the deterrent is fast disappearing. In the most recent article advertising the benefits of such transactions, the sole precautionary note is the advice that taxpayers embarking on bootstrap sales would do well to wait until the decision of the court of appeals in this case becomes final.[40]

The bootstrap sale of a business to charity is a transaction that has no reason for being other than tax avoidance. The conversion of ordinary income into capital gains that it seeks is neither required nor justified by the statute, and the decisions holding otherwise have been criticized no less by private tax practitioners (Moore and Dohan, *Sales, Churches, and Monkeyshines,* 11 Tax L. Rev. 87 (1956)) than by former government attorneys (Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business,* 108 U. of Pa. L. Rev. 623 (1960)). Even lay publicists have noted the abuse as a prime example of the inequitable administration of the tax laws. Stern, *The Great Treasury Raid,* p. 245 (1964). The question is one of major importance and deserves review by this Court.

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[40] *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963).

The court below, having reached a concededly unpalatable result, suggested that the remedy lay with Congress (App. 43). The demonstrated inefficacy of the 1950 amendments should, however, suggest that the answer is not to be found in a particularized legislative response to particularized transactions. The problem is much more fundamental than that; it calls not for the plugging of leaks but for a return to basic principles in the application of the necessarily general provisions of the Code defining capital gains. Deviations from principle always spawn devices to exploit them, and, so long as the basic error remains uncorrected, a new device will take the place of each one struck down by particularized legislation.

Nor can Congress reasonably be asked to essay a specific definition of "sale." The dangers inherent in overly specific legislation are familiar,[41] and in a statute designed to apply to such a multitude of ever-changing transactions as is the Internal Revenue Code there is no alternative to the employment of general concepts, leaving to the courts the responsibility of applying them to particular transactions in a way which serves the underlying purpose. This Court has accepted the responsibility in the past, and no more is now required, we believe, than a reiteration of the

[41] See the history recounted in *Commissioner* v. *Korell*, 339 U.S. 619, and *Hanover Bank* v. *Commissioner*, 369 U.S. 672, for an example of what may (and all too often does) happen when a problem susceptible of flexible solution under a generalized provision of the Code is sought to be solved by particularized legislation.

principles already established by its earlier decisions but widely overlooked by the lower courts.

The petition for certiorari should be granted.

Respectfully submitted.

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APRIL 1964.

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Nos. 18,228–18,233

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILIP F. BROWN, MARILYN BROWN, RESPONDENTS

Petition to Review a Decision of the Tax Court of the United States

December 10, 1963

Before: HAMLIN and DUNIWAY, Circuit Judges and KUNZEL, District Judge

DUNIWAY, *Circuit Judge:* The Commissioner of Internal Revenue asks us to reverse decisions of the Tax Court. We are of the opinion that the decisions must be affirmed.

Involved is a transaction of the type described by Moore and Dohan in an article entitled: "Sales, Churches and Monkeyshines," 11 Tax L. Rev. 87 (1956), and by Lanning in an article entitled: "Tax Erosion and the 'Bootstrap Sale' of a Business," 108 U. of Pa. L. Rev. 623 (1960). The transaction is described in great detail in the findings of the Tax Court, which are reported at 37 T.C. 461. In his

opening brief the Commissioner states: "No exception is taken to the detailed basic findings of the Tax Court." In the same brief the Commissioner summarizes what he contends are the essentials of the transaction. We quote the summary, but with additions, in brackets, from the record:

> "Taxpayers, consisting of Clay Brown, his wife and three children, and the two Booths, owned substantially all of the stock of Clay Brown & Company, which had lumber interests and saw mills near Fortuna, California. Although the total cost basis of their investment was only $42,000, the accumulated surplus of the corporation at January 31, 1953 was $448,472, and prospects of future earnings were good.
>
> In the summer of 1952, Clay Brown, the president of the corporation and spokesman for the other stockholders, was approached by a representative of the Institute, a tax-exempt corporation, who supplied him with brochures describing the tax advantages of a particular type of 'sale' transaction. [There was considerable bargaining, at arms length, and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets.] When, as it happened, taxpayers agreed to the plan, a complex set of interrelated legal documents was drafted to give it effect. Pursuant to the overall plan agreed upon in advance, the following steps were taken:
>
> (a) Taxpayers endorsed and delivered all of their shares in the corporation to the Institute, together with $125,000 face amount of promissory notes of the corporation held by Clay Brown and his wife. On the same day, February 4, 1953, the Institute delivered to taxpayers its promissory note in the face amount of $1,300,000. The note, which was to mature

approximately 10 years later, was nonnegotiable and noninterest bearing. The Institute assumed no liability for payment of the note from its own assets. Payment of the purchase price was to be made solely out of amounts received by the Institute as 'rental' income of the business assets, of which 90 percent would be turned over to taxpayer as periodic installments.

(b) The Institute was left no option as to the disposition of the property, which was provided for in predrafted instruments. The following steps were taken pursuant to the plan: (1) the corporation was dissolved; (2) $5,000 of the current assets was turned over to taxpayers as a down payment; (3) the remaining net current assets were 'sold' for another promissory note to a new corporation, Fortuna Mills, Inc., organized by taxpayer Clay Brown's attorneys for the specific purpose of taking over the business of the dissolved corporation; [All of the issued stock of Fortuna was purchased by the attorneys, with their own funds, for $25,000.] (4) all of the other assets were mortgaged back to taxpayers, permitting reacquisition of [that portion of] the business assets in the event of default on the installments on the purchase price; (5) the same assets were 'rented' by the Institute to Fortuna for 80 percent of the net profits of the business, without allowance for taxes or depreciation. The Institute, retaining 10 percent of this amount, was obligated to turn over the balance to taxpayers to be applied toward the purchase price.

(c) As part of the plan, taxpayer Clay Brown was employed as 'general manager' of Fortuna at an annual salary of $25,000, and it was provided that if he ceased to act as general manager, his successor would be selected by taxpayers. He exercised substantially the same powers as those which he had as president of the dissolved corporation, and no property could be

sold without his consent. Moreover, Brown personally guaranteed mortgage loans of the old company transferred to Fortuna, and he also personally guaranteed another $50,000 loan to Fortuna, which had been capitalized at only $25,000.

The new Fortuna corporation took over the operation of the business, which continued for 4½ years on the same premises, with the same operating personnel and under practical control of taxpayers. On June 19, 1957, after suffering business reverses, Fortuna shut down the mill on word from Clay Brown. Taxpayers did not exercise their option to declare a default and formally reacquire their property by foreclosure. Instead, they arranged for the Institute to sell the assets, retaining 10 percent of the proceeds. The assets, which had been appraised prior to the original 'sale' to the Institute at more than $1,000,000 were sold at only $300,000, to outsiders at sometime in July, 1959. Taxpayer received 90 percent of the proceeds. Steps were taken at that time to settle out and cancel all of the tricornered arrangements between Fortuna, the Institute and taxpayers. The net financial result of the plan was that taxpayers received a total of $936,131.85."

We think we should add to this summary certain additional findings and conclusions of the Tax Court which are:

1. That there was a change of economic benefits in the transaction.

2. That the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research.

In the court below the Commissioner took two alternative positions: One was that the transaction was a

sham. This position is abandoned here. The other, which the Commissioner also takes before us, was that the Tax Court erred in holding that there was a sale within the meaning of section 117(a) of the Internal Revenue Code of 1939 and section 1222(3) of the Internal Revenue Code of 1954 because, so the Commissioner says, certain normal aspects of the sale of a business were missing. These are (1) shift of business risk; (2) shift of benefit of income; (3) shift of operational control; (4) permanent shift of ownership of assets and (5) release of sellers from business indebtedness. The Commissioner relies upon *Burnet v. Harmel,* 1932, 287 U.S. 103 as to shift of business risk, upon *Helvering v. Clifford,* 1940, 309 U.S. 331 as to shift of benefit of income, and on *Commissioner v. Sunnen,* 1948, 333 U.S. 591 as to shift of operational control.

We think that the Commissioner's contentions are well answered in the opinion of the Tax Court, and also in the following cases: *Commissioner v. Johnson,* 1 Cir., 1959, 267 F.2d 382; *Union Bank v. United States,* Ct. Cl., 1961, 285 F.2d 126.

Here, as in those cases, there was a transfer of title; there was a shift of business risk in the sense that the operation of the business was in the hands of a new company owned by third persons, albeit managed under a contract by one of the taxpayers; there was a shift of benefit of income in the sense that Fortuna retained 20% of it and the Institute retained 10% of 80%; there was no understanding that the assets were to come back to the taxpayers under any circumstances other than a default in the payment of the purchase price; there was a permanent shift of ownership of assets. The management contract and the guarantee of certain of Fortuna's borrowings by one of the taxpayers (Clay Brown), were designed

to secure the payment of the price. There was no understanding that, if the business should be unsuccessful, Brown would take action to "trigger" a default, thus causing a reversion of the mortgaged assets to the taxpayers. As was said by the court in *Commissioner v. Johnson, supra,* "The mere fact that the security holders may in the future have to resume proprietorship of the enterprise does not nulify the fact that they had sold those proprietary interests." (267 F.2d at 385)

The Commissioner relies also on *Kolkey v. Commissioner,* 7 Cir. 1958, 254 F.2d 51. This case was distinguished in *Commissioner v. Johnson, supra,* on the ground that in *Kolkey* the facts were different and the Tax Court had found, in substance in that case, that there was no sale. The Tax Court made the same distinction here, and we think it was correct. We think that the real holding in *Kolkey* was that the transaction was a sham. Here, the finding is the other way and the evidence sustains it.

There is no question that this transaction took the form that it did because the Institute is a tax-exempt corporation and that the price to be paid was probably greater for that reason. These facts may have some relevance in connection with possible tax liabilities of the Institute, but they do not, as a matter of law, establish that, so far as the taxpayers were concerned, the sale of their stock was not a genuine sale, which is the only issue involved in this case.

We think that it is of some significance that the problem of misuse by tax-exempt organizations of their tax exemption in transactions similar to this was considered by the Congress, which adopted certain remedial legislation in the Revenue Act of 1950. The history of this legislation appears in H.R. Rep. No. 2319, 81st Cong. 2d Sess., 1950–2, Cum. Bull. 330, 408–

11, and in S. Rep. No. 2375, 81st Cong. 2d Sess., 1950–2, Cum. Bull. 483, 502 ff. Certain aspects of the transaction now before us were undoubtedly "tailored" to fit the law as amended by Congress in 1950, particularly section 101 of the Revenue Act of 1939 as amended, and sections 421, 422, and 423. These sections all relate to the income and tax exempt status of the purchasing Institute; none of them purports to deny to the sellers, the right to treat the sale, for tax purposes, as a sale, and therefore to treat moneys received as capital gains. Congress could have dealt with that aspect of such transactions but did not do so. If, as is indicated by the writers of the articles cited at the beginning of this opinion, the present situation, insofar as the tax position of the sellers is concerned, is undesirable from a tax standpoint, it is still possible for Congress to provide a remedy.

Affirmed.

(Endorsed) Opinion Filed Dec. 10, 1963.

FRANK H. SCHMID, *Clerk.*

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 18228[1]

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN, ET AL., RESPONDENT

Judgment

Upon Petition to Review a Decision of The Tax Court of the United States, _____

_____

_____

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States,

_____

_____

_____ and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the _____ Decision of the said Tax Court of the United States in this Cause, be, and hereby is affirmed.

Filed and entered December 10, 1963

[1] Identical judgments were entered on the same date in favor of Donald L. and Ingrid R. Brown (No. 18229), Charles William and Nancy H. Booth (No. 18230), Donald Lee Brown (No. 18231), Philip F. Brown (No. 18232), and Marilyn Brown (No. 18233).

U.S. GOVERNMENT PRINTING OFFICE: 1964

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FILED
MAY 21 1964
JOHN F. DAVIS, CLERK

In the Supreme Court
of the United States

October Term 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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In the Supreme Court of the United States

October Term 1963

No. 1041

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The findings and opinion of the Tax Court (R. 17-81) are reported at 37 T.C. 461. The opinion of the Court of Appeals (R. 140-145) is reported at 325 F.2d 313.

JURISDICTION

The judgments of the Court of Appeals were entered on December 10, 1963 (R. 146). The petitioner requested and received extensions of time for filing a petition for certiorari from Mr. Justice Douglas on March 11, 1964 and April 3, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether there is compliance with the "sale" prerequisite for long term capital gain where corporate stock is transferred outright to a tax-exempt institution for a fixed price within a reasonable range negotiated in an arms-length transaction, payable over a period of years secured by a mortgage on the underlying assets and by a management contract; or whether compliance with the "sale" prerequisite is nullified by the fact that the tax-exempt institution assumes no personal liability for payment of the purchase price and injects no funds of its own into the transaction thereby making payment of the purchase price dependent upon the earnings from, and value of, the assets transferred.

STATUTE INVOLVED

Sec. 1222 (3) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 Ed) provides that:

> "The term 'long term capital gain' means gain from the sale or exchange of a capital asset held for more than six months * * *."

STATEMENT

As related by petitioner, the Tax Court made detailed findings of fact. (R. 18-57). The abbreviated statement of the facts made by petitioner at pages 3 through 5 of the petition is substantially similar to the summary of facts contained in Petitioner's opening brief to the Court of Appeals and is quoted in the Court of Appeals opinion with certain additions (R. 141-143) which the Circuit Court deemed necessary to accurately reflect the findings of the Tax Court. These supplemental findings added by the Court of Appeals include those quoted below:

> " * * *There was considerable bargaining [between respondents and the Institute] and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets." (R. 141)
>
> "* * * there was a change of economic benefits in the transaction (R. 143).
>
> "* * * the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (R. 143)

ARGUMENT

There is no conflict between the Courts of Appeals on the issue presented, and none is alleged by petitioner in his statement of the question. Nevertheless, petitioner submits in his argument that there is a basic conflict of principle between the decision below and that of the

Seventh Circuit in *Kolkey* v. *Commissioner*, 254 F.2d 51 (Br. 20). To support this decision, petitioner makes the following statement (Br. 20):

> "* * * But that was not the rationale of the *Kolkey* opinion, and in every bootstrap sale the "purchase price" is necessarily wholly arbitrary—being determined only by tax considerations * * *".

Similar statements permeate Petitioner's argument as disclosed by the following quotations therefrom:

> "On the other hand, neither economics nor fairness imposes an upper limits on the price" (Br. 9).

> "There being no economic determinations of the price, the upper limit can be determined only by tax considerations" (Br. 10).

> "The price is not determined by economic forces and is necessarily greater than the cash value of the business * * *." (Br. 17-18.)

> "The bootstrap sale of business to charity is an transaction that has no reason for being other than tax avoidance." (Br. 33.)

All of these statements make it clear that the purported tax evil which petitioner desires to remedy through his petition is a bootstrap sale where the purchase price is wholly arbitrary and is determined only by tax considerations. All of these statements by Petitioner conflict with the findings and the conclusions emphasized by the Court of Appeals below, which findings and conclusions are quoted under respondent's statement, and are repeated below:

> "* * * There was considerable bargaining [between respondents and the Institute] and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation

and the adjusted net worth of its assets." (R. 141)

"* * * there was a change of economic benefits in the transaction (R. 143).

"* * * the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (R. 143)

The instant case just does not involve a bootstrap sale where the purchase price is wholly arbitrary, determined only by tax considerations.

Instead of having a conflict in principle between the decision of the Seventh Circuit in *Kolkey* and the decision below, we have: (i) a decision by the Seventh Circuit which affirmed the decision of the Tax Court that there was no "sale" to a charitable institution qualified for long term capital gain treatment where the purchase price was arbitrary and determined primarily by tax considerations, and (ii) the decision of the Court of Appeals below affirming the decision of the Tax Court that there was a "sale" entitled to long term capital gain treatment where the price was within a reasonable range resulting from considerable bargaining at arms length with a charitable institution primarily motivated by the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the charitable institution to convert the property into money for use in its charitable endeavors. The rule applied in *Kolkey* was similarly applied here—whether under all the facts and circumstances the motive or intention of the parties was to

effect a sale. This is a question of fact and each case will be determined based upon its own particular circumstances. As the Tax Court has indicated in *Anderson Dairy, Inc.* v. *Commissioner*, 30 T.C. 1027, (1963):

> "The problem of determining the *true motive of a purported sale of property* to a tax exempt corporation where the tax exempt corporation in turn leases the property to a newly formed corporation in which the original owners have an interest has arisen recently in several cases. *Estate of Ernest G. Howes*, 30 T.C. 909 (1958), Affd. Sub. Nom. *Commissioner* v. *Johnson*, 267 F.2d 382 (C.A. 1, 1959); *W. H. Truschel*, 29 T.C. 433 (1957); *Emanuel N. (Manny) Kolkey*, 27 T.C. 37 (1956) Affd. 254 F.2d 51 (C.A. 7, 1958); *Union Bank* v. *United States*, 285 F.2d 126 (Ct. Cl. 1961); *Clay B. Brown*, 37 T.C. 461 (1961), on appeal (C.A. 9, June 25, 1962). These cases have reached varying results on the issue. *Since the issue is one of fact*, it is apparent that precedents provide no ready answer." (emphasis supplied)

Perhaps petitioner's attempt to emphasize the importance of the issue is motivated by his knowledge of situations existing in the backlog cases referred to in his brief. Respondents have no knowledge concerning this. However, it is respectfully submitted that the solution consistent with Rule 19 is to wait until a Court of Appeals sustains long term capital gain in a sale to a charity where the price is wholly arbitrary and is determined solely or primarily by tax considerations. It may be assumed that the Tax Court will continue its astuteness in distinguishing the facts in *Kolkey* type sales from those involved in the instant case. Even if a lower court having initial jurisdiction should go astray and sustain

capital gain in a *Kolkey* type sale, there is nothing in the present decisions to indicate that the appropriate Court of Appeals would not cope with the matter.

Should a conflict ever develop between Courts of Appeals, the problem presented might be something for consideration by Congress rather than this Court, particularly since the root of the evil, according to petitioner, lies in the tax exempt status of the purchaser. Denying capital gain to the seller is a rather indirect way of remedying any misuse by tax exempt organizations of their tax exemption. As suggested by the Court of Appeals below at the conclusion of its opinion, (R. 145) if any undesirable situation does exist, the solution is for Congress to amend the provisions of the Internal Revenue Code relating to the income and tax exempt status of the purchasing institution, particularly in view of the fact that the problem of misuse by tax exempt organizations of such exemption in transactions similar to the one here presented, was considered by Congress which adopted certain remedial legislation in the Revenue Act of 1950.

In his conclusion, petitioner asserts that the ruling of the Court of Appeals below was unpalatable to the court, evidently because of the Court's reference to Congress as the proper body to afford any remedy that may be appropriate. The Court below does not in any way indicate a dissatisfaction with the result of its holding. The Court's reference to Congress as the proper remedial body follows the prefacing clause:

"If, as is indicated by the writers of the articles

> cited at the beginning of this opinion, the present situation, insofar as the tax position of the sellers is concerned, it is undesirable from a tax standpoint * * *"

The tax articles referred to are likewise cited in petitioner's argument to this Court (Br. 10). The theme behind these articles is illustrated by the following quotation from *Sales, Churches and Monkeyshines*, 11 Tax Law Review 87 (1956) at page 100:

> "To put the matter into proper focus, a case of a valid sale to a church should be stated. To obtain unquestioned validity, as many as possible of the dangerous factors must be obviated. *An abnormally high purchase price is economically essential to the transaction;* thus the taxpayer commences with one adverse factor." (Emphasis added).

As pointed out by respondents in their brief to the Court of Appeals, the Institute never mentioned during the negotiations that the respondents were entitled to an abnormally high purchase price. If it had, there would have been no bargaining at arm's length resulting in a price that was within a reasonable range in the light of the earnings history of the corporation and of the adjusted net worth of its assets. Again, we find that the instant case does not furnish the platform for the scope of review which petitioner is seeking.

Once it is established that the fixed purchase price was within a reasonable range and that the transaction was an arms-length one, the only remaining objection of the petitioner must relate to the security taken from

the Institute by the respondents.[1] It is difficult to determine whether the petitioner is objecting because the respondents took too much security (a mortgage on the plant and equipment and a management contract) or too little (small down payment and payments geared to earnings). If it is the latter, it is difficult to understand how petitioner gets any solace from the depletion and patent cases, since the courts have consistently allowed capital gain treatment to a seller of mineral rights or patent rights, where the security, if any, was limited to the intangible represented by the patent or the hoped for but undeveloped mineral deposit, and the purchase price was completely unknown and limited to payments from earnings. See cases cited by petitioner in Fn. 23 (Br. 21) and *Barker* v. *Commissioner*, 250 F.2d 864 (CA 5, 1957); *U.S.* v. *Giustina*, 313 F.2d 710 (C.A. 9, 1962); and *Crowell Land and Mineral Corp.* v. *Commissioner*, 242 F.2d 864 (C.A. 5, 1957). It has not even been necessary for the seller to be divorced from an interest in the purchasing corporation. *Mayer* v. *U. S.*, 285 F.2d 648 (C.A. 9, 1960).

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[1] Petitioner can have no real objection to the fact that the buyer does not have personal liability and that the purchase price is secured only by physical assets with a known history of earnings. It is submitted that most sales of investment property are made to buyers who do not assume personal liability and necessarily rely on the future earning capacity of the asset. Indeed, many states by statute forbid personal deficiencies against buyers in sales of real or personal property which may have little or no income producing potential. See for example, Oregon Revised Statutes Sec. 88.070 and California Code of Civil Procedures Secs. 726 and 580 (b).

CONCLUSION

Petitioner's argument attacks a transaction involving an arbitrary purchase price determined solely by tax considerations. This case, however, involves an arms-length purchase for a reasonable price motivated primarily by considerations divorced from the tax consequences of the sale. Thus the federal question which petitioner asserts to be important is not even presented by this case.

Admittedly there exists no conflict with decisions of this Court or between decisions of Courts of Appeals.

It is submitted that under Rule 19 of this Court the petition for writ of certiorari should be denied.

Respectfully submitted,

ROBERT T. MAUTZ

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FILED
MAY 22 1964
JOHN F. DAVIS, CLERK

Supreme Court of the United States

October Term, 1963

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Brief Amicus Curiae in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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IN THE

Supreme Court of the United States

October Term, 1963
No. 1041

COMMISSIONER OF INTERNAL REVENUE,

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vs.

CLAY B. BROWN and DOROTHY E. BROWN, DONALD L. BROWN and INGRID R. BROWN, CHARLES WILLIAM BOOTH and NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN.

Brief Amicus Curiae in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The undersigned is attorney for West Los Angeles Institute for Cancer Research (herein called the "Institute") and as such has filed briefs *amicus curiae* in this case in the Tax Court and United States Court of Appeals for the Ninth Circuit. Clay Brown and the other respondents sold to the Institute the stock of Clay Brown & Company in the transaction which the Commissioner here seeks to characterize as something other than a sale. The tax character of this transaction is significantly involved in *West Los Angeles Institute for Cancer Research v. Commissioner*, Docket No. 94372, now pending in the Tax Court, where the tax exempt status of the Institute is at stake.

Introductory.

The opinions below, jurisdiction, question, statutes involved and statement are adequately presented in the petition for certiorari and respondents' brief in opposition. Accordingly, we will not repeat that material in this *amicus curiae* brief.

Reasons Against Granting the Writ.

The Commissioner wants this Court to grant certiorari and redefine, or perhaps more accurately, undefine, the word "sale" for federal tax purposes.

Particularly, the Commissioner says that "sale," as used in Section 1222(3) of the Internal Revenue Code of 1954, should be interpreted to exclude a "bootstrap" sale, for the purposes of determining capital gain. However, the burden of the petition is not that there is a specific conflict with the decision below by any other decision,[1] but rather that the administration of the income tax law is hampered by an unduly legalistic concept of "sale."

This case presents a study in the increasingly prevalent administrative process whereby commercial transactions made in reliance upon an apparently obvi-

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[1]The decision below is in accord with *Union Bank v. United States*, 285 F. 2d 126 (Ct. Cl. 1961), involving parallel facts, with the decision upon somewhat similar facts in *Commissioner v. Johnson*, 267 F. 2d 382 (C. A. 1, 1959), affirming *Estate of Ernest G. Howes v. Commissioner*, 30 T. C. 909 (1958), and with a number of Tax Court decisions, which are cited in the petition and brief in opposition. *Emanuel N. Kolkey v. Commissioner*, 254 F. 2d 51 (C. A. 7, 1958), affirming 27 T. C. 37 involved an ephemeral corporation that was established solely to make the purchase, was always controlled by the sellers through a staggering note issue which they owned, and was wholly reacquired by the sellers before the end of its first fiscal period; it is clearly distinguishable from the present situation of purchase by an independent entity unrelated to the sellers.

ous application of the tax statutes, are *ex post facto* reinterpreted by the Commissioner to involve an alleged "substance" and tax law impact that violates the original understanding of the parties. Frequently, the Government attack is mounted on a large scale, using the resources of its many offices, its access to courts around the nation, and its unlimited financial resources, in a display of power which the taxpayer cannot match and the defense against which calls for a frightening outlay of time, effort and expense. This process can be well-nigh ruinous in some cases; it has already caused reorganization of and severe hardship upon the Institute, as explained in its brief *amicus curiae* to the Ninth Circuit Court of Appeals (pp. 21-22); it should go no farther.

The most extreme application of this process occurs when Congress has enacted particular remedial legislation at the Commissioner's request, and parties have entered into a transaction in conformance with the remedial statute, but the Commissioner, still dissatisfied, decides in retrospect upon some ground of "substantive" reinterpretation that not only is at variance with the intention of the parties but also stultifies the remedy provided by Congress. This has happened here.

The remedial legislation was the 1950 amendments to the provisions of the Internal Revenue Code concerning exempt organizations and their participation in business activities; the amendments are described beginning at page 26 of the petition, and at pages 13 and subsequent of our brief *amicus curiae* to the Ninth Circuit. It is apparent from the Committee Reports there referred to that Congress was primarily concerned with the tax advantage enjoyed by a business owner who

made a "bootstrap" sale of the business to a foundation which, while risking no down payment or personal liability, thereupon used tax exempt income from the business to pay the purchase price. A detailed statutory remedy was provided by Congress; generally speaking, it removed the tax exemption for business operating income, and taxed to the foundation rental paid by an operating lessee for real and personal property according to a formula; no tax on rent from a lease up to five years; rent to be otherwise taxable in the proportion of financed purchase price to depreciated cost of the property.

Congress did not provide that a "bootstrap" sale should be treated as no sale. Conversely, if after all these years the Court were to so hold, what Congress did provide in 1950 would have been largely unnecessary.

The Institute, in specific reliance upon the 1950 amendments, purchased two businesses and leased for five years the real and personal properties obtained; the first of these transactions occurred in 1951; the second, the one now before the Court, in 1953.

The Commissioner's retroactive attack upon these transactions began with Rev. Rul. 54-420, 1954-2 Cum. Bull. 128, issued in the fall of 1954. For the Commissioner, the process of substantive reinterpretation by afterthought is a happy one, since his procedure is to merely challenge a transaction as being substantively not what the parties intended. Note the lack of reason or authority in Rev. Rul. 54-420. He may then reformulate his theory from time to time, according to his experience administratively and in the courts. Note the metamorphosis of the Commissioner's "theory" in this case

through his briefs in the Tax Court and Ninth Circuit to the petition here.

By contrast, the Institute and sellers to it have gone through ten dismal years of administrative and court proceedings in forum after forum, in which the Commissioner has refused, for vague and ever-changing reasons, to accept as a sale a transaction that was clearly a sale in law and in the understanding of the parties who negotiated it at arm's length and in good faith.

We are unable to comprehend the suggestion that this transaction was tailored to circumvent the 1950 amendments. (Petition, p. 29.) The agreements here provided that the fixed price be paid by the Institute out of a percentage of rental collected, but with minimum fixed biennial installments; under the five-year lease granted by the Institute, rents were contingent upon income but again were payable in fixed minimum biennial installments; in providing for contingent rents (versions of which are commercially common) and for a rate of price payment geared to rent collection, the parties here made an arrangement anticipated and regulated by Congress. Congress laid down specific requirements for use of tax exempt rental income for purchase of business property; the transaction in issue was designed to meet those requirements, not circumvent them.

The purpose was worthy. The Institute, which was entirely unrelated to Clay Brown, wanted to acquire his property in order to have resources for cancer research.

If this purpose or the means employed are unworthy in the Commissioner's eyes, he should return to Congress. He should not continue harassment of the Institute and sellers to it by protracting this litigation.

The petition (pp. 7 and subsequent) contends generally that a "bootstrap" sale makes no economic sense because the price is dictated by the seller solely to serve his tax purposes; therefore, it should not be treated as a "sale" providing capital gain.

Consider the business owner who is nearing retirement and decides to sell his business to key employees; the alternatives being to liquidate it, thereby throwing people out of work, or to merge it into a large corporation, thereby contributing to the disappearance of small business. Typically, the key employees have little if any down payment to spare and are unwilling to incur significant indebtedness (indeed, in California, where the Institute resides, purchasers are not expected to incur personal liability for purchase money debt).[2] It will take some years for these employees to pay the price in installments out of earnings of the business; they can be expected to agree to more than an all-cash price, but not to an unconscionable price that would too long defer their unencumbered ownership and enjoyment. Once the deal is made, the buyers will cling to "their" business; and woe betide the seller who may think he still owns it. Would it be the Commissioner's position, after the many decades that such a transaction clearly has been a "sale" for income tax purposes, that it is now to be classified as something else by Supreme Court decision? One can well imagine the chaos of uncertainty that would result from such a holding; some of which the Commissioner has foreseen and been frank enough to acknowledge. (Petition, pp. 22-23 and footnote 29.)

[2]In California, even in absence of a contract provision, there is no personal liability on purchase money debt for real and personal property (C. C. P. §§ 726 and 580(b)); in Oregon there is none on purchase money debt for real property (O. R. S. 88.070).

We trust that the Court will turn a deaf ear to the Commissioner's plea that the word "sale" shall no longer have a generally understood meaning, but shall join the word "debt"[3] and other words and concepts which have, for tax purposes, such meaning as the Commissioner may assign to them by afterthought.

Dealing at arm's length with unrelated parties, the Institute bought the stock of Clay Brown & Company, dissolved the corporation, and leased its assets to Fortuna Sawmills, Inc. The parties expected the price to be paid from rent. The Institute would have prevented foreclosure by independent financing if that had been warranted by the value of the property. It was only because of unexpectedly drastic adversity in the lumber business at the Fortuna location that the property had to be sold by the Institute to the State of California for its salvage value. In spite of this unexpected deterioration and default, the sellers were unwilling to face the problems of foreclosure and never did foreclose.

Substantially, this is the picture of a deferred payment sale and purchase of property. It does not lie with the Commissioner, who was not a party to a transaction of such legal and economic significance, later to interpret it in manner suitable only to himself.

There is no reason in justice or the Court's practice for granting certiorari in this case. The petition should be denied.

May 1964.

Respectfully submitted,

ARTHUR A. ARMSTRONG,
Attorney at Law.

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[3]See, *e.g.*, 4 Mertens Law of Federal Income Taxation 26.10 and subsequent.

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (R. 17–81) is reported at 37 T.C. 461. The opinion of the court of appeals (R. 291–296) is reported at 325 F. 2d 313.

JURISDICTION

The judgments of the court of appeals were entered on December 10, 1963 (R. 296–299). By orders dated March 11, 1964, and April 3, 1964, Mr. Justice Douglas extended the time for filing a petition for certiorari to and including April 24, 1964 (R. 299). The petition

for certiorari was filed on April 24, 1964, and was granted on June 8, 1964 (R. 300; 377 U.S. 962). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether a transfer of stock in which the transferor receives nothing but (1) a right to have remitted to him, until he has received a stated amount, whatever income accrues to the transferee from the ownership of the stock (or the underlying corporate assets), and (2) a right to recover the stock (or the assets) if the stated amount has not been remitted by a prescribed date, is a "sale" of the stock within the meaning of § 1222(3) of the Internal Revenue Code of 1954 (and § 117(a)(4) of the 1939 Code), entitling the transferor to report the income thereafter remitted to him only as long-term capital gain, or is a transfer of the stock with a retained income interest, making the remitted income taxable to the transferor as ordinary income.

STATUTE INVOLVED

Section 1222(3) of the Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.) [1] provides that:

> The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

STATEMENT

This case involves deficiencies in personal income taxes asserted by the Commissioner of Internal Reve-

[1] § 117(a)(4) of the 1939 Code (26 U.S.C., 1952 ed.) is identical.

nue against the respondent taxpayers variously for the calendar years 1953, 1954, 1955, and 1956 (R. 97–98). In each instance the question is whether items of income received in those years by some or all of the taxpayers as a result of a transaction described below should have been reported and taxed as ordinary income, as the Commissioner asserts, or as long term capital gain, as the taxpayers maintain. The Tax Court, with six judges dissenting, disallowed the asserted deficiencies (R. 17–81). Its determination was affirmed by the Court of Appeals for the Ninth Circuit (R. 291–296). The Tax Court made extensive Findings of Fact (R. 20–58), some of which describe or paraphrase documents introduced by stipulation between the parties. The central documents are reproduced in the record (R. 161–287).

A. BACKGROUND AND GENERAL DESCRIPTION OF THE TRANSACTION

1. In 1952, Clay B. Brown was President of Clay Brown & Company (the "Corporation"), a corporation engaged in lumber milling. He, his wife Dorothy, his sons Donald and Philip, and his daughter Marilyn (all taxpayers and respondents herein), each owned 6,000 shares of the stock of the Corporation, aggregating 30,000 of its outstanding 32,000 shares of stock. Donald Brown was Assistant Vice President of the Corporation. Charles W. Booth was Secretary-Treasurer of the Corporation, and he and his wife Nancy (taxpayers and respondents herein) owned an aggregate of 1,500 shares of the stock of the Corporation. The remaining 500 shares were owned by C. A. Hill,

Vice President of the Corporation. Mr. Hill, as a stockholder of the Corporation, participated in the transactions hereafter described, but is not a party to this litigation (R. 21).

The Corporation had been formed in 1946, at which time each of the above listed members of the Brown family acquired 6,000 shares of its stock at a cost of $1 per share. Prior to 1950, the Corporation operated solely as a commission broker in the sale of lumber products produced by others. In the latter part of 1949, however, it acquired a log supply and a tract of land near Fortuna, California, and constructed a sawmill (Ex. 21–U, R. 163–164). The mill was put into operation during February, 1950, and an additional unit was added in 1951. (R. 21.) The sales and executive offices of the Corporation were maintained in Portland, Oregon, where Clay D. Brown and his wife resided; a sales office was also maintained in San Francisco (R. 95, 98–99). At the close of its fiscal year ending April 30, 1952, the Corporation's net worth was $397,782.10 (Ex. 21–U, R. 167). Its net income for that fiscal year, before federal income taxes, was $144,472.05; its after-tax income, $77,078.33 (Ex. 21–U, R. 161).

2. In October or November, 1952, after exploratory inquiries, a member of an investment firm brought Clay B. Brown together with Louis H. Seagrave, the chairman of the board of directors of the California Institute for Cancer Research (the "Institute"),[2] a

[2] The Institute's name was later changed to the West Los Angeles Institute for Cancer Research (R. 23).

tax-exempt charitable organization. The Institute was interested in becoming the owner of closely held businesses in accordance with procedures set forth in a brochure (Ex. 24–X, R. 170–179) prepared by Seagrave in consultation with an attorney for another tax-exempt organization in Los Angeles, a copy of which was furnished to Brown. (R. 24). The brochure outlined the mechanics of such a transaction—which was in the form of a sale of stock to the Institute—and described its advantages to the owners of a business (R. 172–173):

> Many owners of a closely held, successful business find it difficult to get any considerable part of the corporate profits into their personal possession, after providing for both corporate and personal federal and state income taxes.
>
> Working with the California Institute for Cancer Research, we have been able to solve this problem for a number of owners of sound concerns, having a strong current position, and valuable fixed assets consisting of land, buildings and operating equipment, achieving the following for the sellers:
>
> 1. They can sell their business to the Institute for more than they can sell for cash, for payment over a period of years, frequently with a substantial down payment [to be taken from the corporation's assets, R. 170].
>
> 2. They continue to control the business operation and to draw their regular salary, and retain an interest in the profits as well, until they are ready to retire.
>
> 3. They pay only a long term capital gains tax (26% federal).

* * * * *

> 5. They avoid the perplexing predicament of either paying prohibitively high personal taxes on distributed corporate earnings, or risking heavy penalties under Section 102 [1939 Code] for unreasonable accumulation of surplus if earnings are not distributed.

With Brown's expression of interest in such a transaction, there followed lengthy negotiations, conducted at arm's length with the participation of both lawyers and accountants, which ultimately resulted, on February 4, 1953, in a "sale" of all of the stock of the Corporation to the Institute in accordance with the procedure set forth in the brochure (R. 29–39).

The documentation of the transaction was intricate and will be described in more detail below, but its principal operative features were relatively simple. The stockholders conveyed their stock to the Institute; the Institute liquidated the Corporation and transferred its assets to a new operating company (the stock of which was owned by Brown's attorneys); and the operating company, employing Brown as general manager, continued to carry on the business with no change in the method of operation. In return, the operating company was to pay over to the Institute, as "rent" for the use of the properties, 80% of its net profits before taxes or depreciation. The Institute was to remit 90% of the amounts it received to the stockholders, as payments of the "purchase price" for the stock, until the sum remitted aggregated $1,300,000, whereupon the stockholders' interest was to terminate and the Institute was to have the complete beneficial ownership of the business. If the remittances to the stockholders fell behind a pre-

scribed schedule (at least $250,000 every two years), the stockholders could "foreclose" on the properties for payment of the remaining amount, but the Institute was to have no personal liability beyond its agreement to remit 90% of whatever it received from the operating company. In brief, the stockholders conveyed their stock to the Institute in exchange for (1) a right to 72% (90% of 80%) of the net profits of the business until they had received $1,300,000, and (2) a right to recover the properties (or a share of their proceeds) if the remittances fell behind a prescribed schedule (R. 37–42).

The tax advantages which were to compensate the stockholders for the ultimate loss of the business were considered at length in an 11-page memorandum submitted to Brown by his attorneys (Ex. 58–FFF, R. 264–274). The tax advantages there explored—and which were acknowledged to be what "makes the proposal of the Institute possible" (R. 270)—were two-fold:

> (1) the deduction of the "rents" by the operating company combined with the Institute's tax exemption would eliminate any corporate taxes on the business earnings, thereby substantially doubling the amount of business income available for distribution (with the corporate income taxes otherwise applicable being at a rate in excess of 50%) (see R. 270–273); and
>
> (2) with the transaction taking the form of a sale of the stock, the remittance to the stockholders of those enhanced amounts of earnings would be subject only to the very favorable long-term capital gains rates of tax, rather than to the much higher rates on ordinary income nor-

mally applicable to distributions of corporate earnings (see R. 266–269).

The attorneys noted that the treatment of the transaction as a "sale" of the stock was the feature "of primary importance to you" (R. 266) and cautioned Brown that "The more the deal is a straight sale of the stock * * *, the better your tax position" (R. 268).

B. THE DETAILS OF THE TRANSACTION

While the details of the transaction and the terminology employed in the complex set of documents by which the transaction was consummated have little significance in the view we take of the case, the nature of the instruments and their characterization for State law purposes seemed significant to the courts below and will presumably be relied upon by respondents. To give the Court the full flavor of the transaction in those terms, therefore, it is appropriate that we set out the documents and explain the effect of each in some detail.

1. All of the steps of the transaction, and all of the other documents to be executed, were set forth in a "Purchase Agreement" dated February 4, 1953 (Ex. 32–FF, R. 197–206). With a single exception to be noted, all of the other documents were also executed as of the same date (R. 37–40). Preparatory to the transaction, a new corporation, Fortuna Sawmills, Inc. ("Fortuna"), was formed to serve as the operating company. All of its $25,000 in capital stock was owned by two members of the law firm which represented Mr. Brown and the Corporation, and they, with a third member of the firm, became the officers and directors of the new corporation

(R. 104). Then, under date of February 4, 1953, and as provided for in the "Purchase Agreement," the following steps occurred:

a. The stockholders transferred to the Institute all their stock in the Corporation (R. 37).[3]

b. A newly installed board of directors caused the Corporation to be liquidated and all its assets to be transferred to the Institute (R. 39–40, 101–103; Exs. 33–GG through 43–QQ, not reproduced in the printed record).

c. The Institute paid over to the stockholders $5,000 in cash from the assets received from the Corporation (R. 37–38).

d. The Institute transferred all of the remaining assets to Fortuna. That was done under two separate instruments:

> (1) The land, buildings, equipment, and other fixed assets were transferred to Fortuna under a "Lease and License Agreement" with a five-year term (Ex. 49–WW, R. 215–216). As "rent," Fortuna agreed to pay to the Institute at semi-annual intervals an amount equal to 80% of its "net profits before depreciation, income, franchise, excess profits or other similar federal or states taxes" (R. 216). Fortuna was required to employ Clay B. Brown as General Manager (R. 222) and agreed to "exert its best efforts at all times to cause the demised premises to be pro-

[3] Notes against the Corporation in the amount of $125,000, held by Clay Brown and his wife, were also conveyed and cancelled as part of the transaction (R. 37). The difference between the notes and the stock is not material for present purposes, however, and for simplicity we will hereafter treat the transaction as involving only stock.

ductive of the highest possible net profits consistent with good business judgment and sound and economical operations" (R. 217). Fortuna was to maintain the property, pay the insurance premiums and taxes, and bear any operating losses (R. 216–219). Until the claims of the former stockholders were satisfied, the "Lease" could not be amended without the consent of Clay Brown, and should Mr. Brown be unable or unwilling to act as General Manager his successor was to be approved by the majority in interest of the former stockholders (R. 222). [If the stockholders' claims were not satisfied by the end of the five-year term, it was contemplated that a new lease would be made with the same or a different corporate entity (see R. 26–27).]

(2) The current assets of the old Corporation (cash, bank accounts, inventory, accounts receivable, *etc.*) were transferred to Fortuna by a "General Assignment to Fortuna Sawmills, Inc." (Ex. 50–XX, R. 235–236). In exchange, Fortuna executed an "Assumption Agreement of Fortuna Sawmills, Inc.," whereby it assumed all the debts of the old Corporation and agreed to give the Institute a "Promissory Note", payable without interest at the end of the lease, for the amount by which the book value of the current assets exceeded the debts assumed (Ex. 51–YY, R. 237–238). That excess was later determined by an audit to be $20,991, and in due course (on May 15, 1953) Fortuna executed the required note in that amount (Ex. 52–ZZ, R. 239–240).

e. In exchange for the stock of the Corporation, the Institute gave the stockholders a noninterest-bearing "Promissory Note" for $1,300,000 which was expressly stated to be non-negotiable (Ex. 44–RR,

R. 211–213). By the terms of the "note," the Institute agreed to pay $5,000 forthwith upon the liquidation of the Corporation (see paragraph *c*, above) and thereafter to pay, within five days of receipt, 90% of "all royalties or rents received in cash" from the lease of the assets to Fortuna (see paragraph *d*, above) or any substitute lease. The Institute had the right, but no obligation, to make payments from other sources. The entire balance of the note was to "become due and payable on" January 1, 1963, but the stockholders could accelerate payment if the payments were less than $250,000 in any two-year period. Upon any default in payment, the stockholders' sole recourse was against the security given for the note (see paragraph *f*, following).[4]

f. As security for the "Promissory Note" given the stockholders, the Institute executed (R. 103–104):

> (1) a "Deed of Trust" and a "Chattel Mortgage" covering all the fixed assets received by it on the liquidation of the Corporation and leased to Fortuna (Exs. 45–SS and 46–TT, not reproduced in the printed record);[5] and

---

[4] The "Promissory Note" expressly incorporated the terms of the "Purchase Agreement" for the detailed definition of the Institute's obligations (R. 211–212). The limitation of the Institute's liability to the remitting of 90% of the amounts received from Fortuna, implicit on the face of the note, is made explicit in paragraphs VI and VIII of that agreement (Ex. 32–FF, R. 200).

[5] Those instruments in terms obligated the Institute to pay for insurance premiums, taxes, maintenance and repairs on the mortgaged property (undertakings which Fortuna also made to the Institute), but the stockholders furnished the Institute a letter assuring it that they would "never attempt to enforce * * * said provisions against your Institute personally"

(2) a "General Assignment" of (a) the note to be given it by Fortuna for the current assets and (b) 90% of the rent to be paid by Fortuna under the lease of the fixed assets (Ex. 47–UU, R. 213–215).

2. Omitting the procedural steps and the characterizations used by the parties, the overall effect of the transaction may be simply stated. Except for the $5,000 in cash withdrawn and given to the stockholders, all of the assets of the old Corporation were transferred as a going business to a new corporation which, employing the same personnel, continued to operate the enterprise in exactly the same fashion as it had been operated before. The only difference was that the net earnings of the business (before income taxes or depreciation) were now to be distributed 8% to the Institute and 72% to the former stockholders. If the amounts distributed to the stockholders aggregated $1,300,000 within a ten-year period, their interest in the business was to terminate, and the Institute would then have complete beneficial ownership of the business and its assets. Otherwise (unless the Institute chose to volunteer payment from other sources), the stockholders were entitled to recover the properties (or a share of their proceeds) and terminate the Institute's interest.

What the stockholders hoped to gain by the transaction, we have already shown (enhanced distributions of business earnings, undiminished by corporate

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and that any default "shall entitle the [stockholders] only to proceed with foreclosure proceedings" against the pledged property (Ex. 83–EEE, not reproduced in the printed record; see R. 44–47, 112).

taxes, which would be taxable to them only as capital gains). What the Institute hoped to gain was the 8% of the business earnings to be distributed to it currently plus, ultimately, the full ownership of the business. Its hope of receiving the assets might or might not ever materialize, but beyond the failure of its hopes it could lose nothing. From its own resources, it was to pay, and paid, nothing; it was to risk, and risked, nothing.

C. EVENTS FOLLOWING THE TRANSACTION

1. Following the transaction, the business continued in operation as before, on the same premises, with the same personnel, and under the same management (Clay Brown being paid as General Manager of Fortuna the same salary he had previously received from the Corporation, $25,000 per year) (Ex. 53-AAA, R. 240-241; R. 26, 44, 47). Fortuna borrowed money to meet its current needs from the same bank that had previously financed the Corporation, and Clay Brown personally guaranteed one of its loans in the amount of $50,000 (R. 49).*

* Clay Brown resigned as general manager as of October 31, 1954, but he continued to serve "in an advisory capacity" with a salary of $12,000 and with authority to sign corporate checks (R. 48). The directors resolved not to appoint a successor as general manager since, with Mr. Brown remaining available in an advisory capacity and with Messrs. Booth and Hill already overseeing the Portland office and the mill, none was needed (R. 130, 132-133). Clay Brown continued his periodic visits to the mill and his voice seems to have continued to be dominant one, whatever his formal capacity (R. 130-133). Whether his resignation was precipitated by the advice of tax counsel is unclear (see R. 49; Ex. 57-EEE, R. 257-258, 262).

2. During the period from February 4, 1953, through April 30, 1956, Fortuna made semi-annual payments to the Institute of 80% of its net profits, and the Institute remitted 90% of those payments to the former stockholders. As of the end of the fiscal year ending April 30, 1956, payments from Fortuna to the Institute had amounted to $716,622, and the Institute had remitted $651,094 to the stockholders (R. 56; Ex. 73-UUU, R. 275–277).

Beginning in November 1956, Fortuna suffered heavy losses (over $125,000 in the six-month period ending April 30, 1957) as a result of a decline of lumber prices and a change in freight rates, and in June 1957 the mill was shut down (R. 50). A series of disagreements then developed between the Institute and both the former stockholders and Fortuna, but they were ultimately resolved by a further agreement (R. 54). In 1958, pursuant to the agreement, the mill properties were sold to the highway department of the State of California for $300,000 and the net proceeds were divided 10% to the Institute and 90% to the stockholders, whereupon the relationship between the Institute and the former stockholders was terminated (R. 54–55). These last payments are not involved in the present litigation, since 1956 is the most recent taxable year at issue.

D. THE PROCEEDINGS BELOW

Using the installment method, each respondent offset a proportionate part of his basis in the stock against the amounts remitted to him each year by the Institute and reported the net gain as long-term capi-

tal gain. The Commissioner of Internal Revenue held that the transaction was not a "sale" within the meaning of § 1222(3) of the Internal Revenue Code of 1954[7] and that the gains for the years 1953-1956 were taxable as ordinary income, determining deficiencies accordingly (R. 57).

The full Tax Court (R. 57–72), with six judges dissenting (R. 72–81), held the transaction a "sale" and the gains taxable only as capital gains. The court noted that "It may be * * * that [respondents] would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," but said that a taxpayer has the right "to increase the amount received from a transaction over what he might have received from a different transaction" and that a sale is not to be ignored "solely because the exempt organization is willing to pay a somewhat higher price than someone else might pay" (R. 62).[8]

The court of appeals affirmed (R. 291–296). Although acknowledging that the transaction took the form it did because the Institute was tax-exempt and that "the price to be paid was probably greater for

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[7] The first year involved is governed by the 1939 Code, § 117 (a)(4) of which is identical, but for convenience all section references in this brief will, unless otherwise indicated, be to the 1954 Code.

[8] The price was, moreover, a "result of real negotiating" and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth" (R. 64), confirming that the Institute acted at arm's length with a real expectation that the earnings would be sufficient to permit full payment and that there was no "tacit understanding" that the transaction would collapse, permitting respondents to recover possession (R. 63–64, 36).

that reason" (R. 295), it held that the transaction was a "genuine sale" because there was a transfer of title, of permanent ownership, of the benefit of part of the current income, and of the operation of the business (R. 294–295).

SUMMARY OF ARGUMENT

I

Despite the complexity of the transaction, the issue in this case can be reduced to very simple terms: Is a transfer of stock in which the transferor receives nothing but (1) a right to have the dividends remitted to him until he has received a stated sum, and (2) a right to recover the stock (or a share of its proceeds) if the stated amount has not been remitted by a prescribed date, a "sale" of the stock within the meaning of the capital-gain provisions, entitling the transferor to account for the dividends thereafter remitted only as capital gains? While the actual transaction included some further steps the purpose of which was to eliminate the corporation income tax and thus increase the yield to be remitted to the respondents—to wit, the Institute's liquidation of the corporation and transfer of its assets to Fortuna—those further steps have no bearing on the issue in this case: was the initial transfer of the stock to the Institute a "sale"? That question would be exactly the same if the corporation had not been liquidated and the Institute's obligation to remit the income had been defined in terms of the dividends to be paid by the old corporation rather than in terms of the yield from liquidating the corporation and "leasing" its assets. For simplicity of analysis, therefore, we may assume that the

corporation was not liquidated, that the Institute's obligation was to remit 90% of the dividends received from the corporation, and that the respondents' rights of recourse if the remittances fell behind schedule were against the stock itself.

II

Analyzed in economic terms, a transaction in which *A* transfers stock to *B* solely for *B*'s promise to remit the dividends up to a stated amount, with *A* having the right to recover the stock (or a share of its proceeds) if the amount has not been remitted by a certain time, makes no sense. Since *A* was previously entitled to receive all the dividends without limit yet retain full ownership of the stock, the transaction gives him nothing he did not have before and amounts simply to the voluntary imposition by him of a limit on his previously unlimited rights. If donatively motivated, such a transaction would plainly be but a conditional gift by *A* to *B* of a future interest in the stock, to become possessory if, by a prescribed date, the dividends remitted should reach a stated amount. If the transaction is concluded between parties negotiating at arm's-length with each other—as it is agreed this transaction was—the terms are necessarily arbitrary, since *B*, contributing nothing, has nothing to bargain about. The only explanation of such a transaction is the hoped-for tax benefit—namely, the hope that it will be treated as a "sale" and cause the dividends subsequently remitted to *A* to be taxed only as capital gains, an advantage which, if the amounts to be remitted are sufficiently greater than the presently-realizable value of the stock, will more than

make up for *A*'s ultimate surrender of the stock. Since no reasonable man moved only by economic considerations independent of taxes would agree to such a transaction with a stranger however great the stated amount of dividends to be remitted might be, and since the stated amount must be substantially greater than the present value of the stock for the transaction to yield even a tax advantage, it must be presumed that the amount agreed upon in such a transaction between strangers is in fact—as the courts below acknowledged it probably was here—substantially greater than the value of the stock at the time of the transaction. And if the stated amount is greater than the present value of the stock, it is evident that *A* not only continues to bear the full risk of future losses but also will receive, up to the self-imposed limitation, the benefit of any future gains or profits.

That does not mean, however, that the transaction lacks "substance" or is a "sham," for it does have some very real substantive consequences. Not only is there an immediate transfer of legal ownership—and with it, for example, the voting rights in the stock—but there is the very real possibility that the stock will "buy itself out" and *B* will end up with the full beneficial ownership. The question, then, is not whether the transaction has "substance" but whether its substance is that of a "sale" or—as we contend it is—that of a transfer with a retained income interest.

III

The basic difference between sales and reserved-income transfers, we submit, is that in sales the pri-

mary burden of future losses and the full benefit of future gains and profits are shifted to the transferee, while in reserved-income transfers the transferor remains dependent for payment upon, and thus shares in, the future gains and profits from the property. If so, it follows that the transaction in this case—in which neither the risk nor the benefits of future gains or losses were shifted—is not a sale.

That a transfer of stock solely on the transferee's promise to remit the dividends for a time or up to a stated amount is not a "sale" is established not only by the lower court decisions but by this Court's decisions holding that a transfer of mineral interests on the transferee's promise to remit a stated amount out of any oil produced is not a sale. And as those cases show, the question turns, not upon the passage of legal title, but solely upon the transferor's economic dependence upon the future production of income from the property.

A transfer of stock in exchange for a substantial down payment, the transferee's promise to remit the dividends up to a stated amount, and a right to recover the stock (or a share of its proceeds) if the stated amount has not been paid by a day certain is, on the other hand, equally plainly a sale. The difference is not in the labels used by the parties. Nor can it be that there is a transfer of ownership as a matter of property law, for that is equally true of transfers with a retained income interest. The difference is rather that the down payment leaves the stock as security for only a fraction of the purchase price, thereby giving the transferor a reasonable assurance

of payment independent of the future dividend yield and of at least substantial changes in the value of the stock. The primary risks of future losses and the benefit of future gains are thus shifted to the transferee. The result is a "conversion" of the transferor's former "equity" interest in the stock—bearing the risks and realizing the benefits of gains and losses—into a secured "creditor's" claim against it, and that in turn is what a "sale" is all about.

The transaction here differs from the clear case of a reserved-income transfer in that respondents also had the right, if the remittances fell behind a prescribed schedule, to cause the stock to be sold and to recover the balance due out of any proceeds. But if our analysis of the basic difference between sales and reserved-income transfers is correct, such a "foreclosure" right is relevant only to the extent that it does in fact afford reasonable assurance of payment independent of future gains or profits from the property. Since in this case the amount to be remitted must be presumed to have been substantially greater than the present value of the property—for there can be no other explanation of the transaction—the right of recourse against the property provided no assurance of payment. By the same token, respondents continued to share the benefits from any future gains or profits, since it was only from such gains or profits that they could be paid. There was thus no "conversion" of the respondents' interests, through risk-shifting, from an "equity" interest in the stock to a "creditor's" claim against it, and hence there was no

"sale." Respondents merely imposed a limit upon their previously unlimited rights to receive the future gains and profits from the property and thereby made a conditional gift to the Institute of a future interest in the property.

That treatment is required also by the declared purposes of the capital-gains provisions, which, as stated in the committee report, was to afford special treatment to the realization, by a sale, of "gains and profits earned over a series of years" *prior to the sale.* That purpose requires that capital-gains treatment be limited to amounts representing a realization upon the present value of the property at the time of the transaction. And to hold that this transaction was a sale would, as we have shown, result in according capital gains treatment to the respondents' receipt of the ordinary profits produced by the property after the transfer.

IV

Transactions in which the transferee contributes, either by making a further investment or by furnishing services, to the production of the income to be remitted to the transferor pose a different question, since the transferee's contribution may itself, at least in some situations, cause a significant shifting of the primary risks. The decision here ought, therefore, to be confined to transactions in which, as here, the transferee performs a purely passive role, merely collecting and remitting income to the production of which he has made no contribution.

V

If the transfer of the stock to the Institute was not a "sale," the questions that remain as to the effect upon respondents of the subsequent steps of the transaction (the liquidation of the corporation and the transfer of its assets to a new corporation) are not essentially different from those that would be presented if respondents had not purported to "sell" their stock to the Institute but had themselves liquidated the corporation and transferred the assets to Fortuna on the same terms. That transaction would present the questions, for example, whether the liquidation of the old corporation and the transfer of its assets to a new corporation qualified as a tax-free "reorganization" and whether, even if there was no reorganization, the "lease" of the assets to Fortuna for 80% of its net profits should, on "thin capitalization" principles, be treated as giving rise to an "equity" or "stock" interest in Fortuna, making the "rental" payments non-deductible "dividends." Those questions, however, are entirely separate from the question whether the initial transfer of the stock constituted a "sale"; no issue has yet been raised about them by the parties; and they have not been passed upon by the courts below. None of those questions is now before this Court, therefore, and the decision here should be confined to the "sale" question, leaving to the lower courts on remand the effect, if any, of the subsequent steps upon respondents if the initial step was not a sale of the stock.

ARGUMENT

INTRODUCTORY

The transaction in this case involves a highly-publicized and widely exploited device the primary objects of which are (1) to eliminate the corporation income tax on business earnings and (2) to cause the distribution of the earnings to the former stockholders to be taxed only as long-term capital gains.[9] The transaction requires the participation of a tax-exempt entity to whom the stockholders must suffer the ultimate ownership of their business to pass, but the tax savings are so great that the stockholders are more than compensated. The plan has been developed primarily by advisers to tax-exempt institutions, but so attractive is it to the owners of a closely-held business that a single institution[10] has been able to acquire 26 different businesses (at an average price of $1.3 million each) by that means. The principal deterrent to date against an even wider exploitation of the transaction has been the fear that the tax consequences upon

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[9] See Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. of Pa. L. Rev. 623 (1960); Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87 (1956); MacCracken, *Selling a Business to a Charitable Foundation*, 1954 U. of So. Calif. Tax Inst. 205; Comment, *The Three-Party Sale and Lease-Back*, 61 Mich. L. Rev. 1140 (1963); Alexander, *The Use of Foundations in Business*, 15 N.Y.U. Tax Inst. 591; *New Developments in Tax-Exempt Institutions*, 19 Journal of Taxation 302 (1963). See also Stern, *The Great Treasury Raid*, p. 245 (1964).

[10] The University Hill Foundation in Los Angeles, which was a participant, for example, in all of the cases cited in note 11, *infra*, and in the *Union Bank* case cited in note 13, *infra*. It was the attorney for the University Hill Foundation (which is associated with Loyola University) who aided Mr. Seagrave in preparing the brochure used by him (R. 24).

which it depends might be successfully challenged. But if the doubts are authoritatively resolved in favor of the transaction, there is no reason why any high-bracket owner of a business should continue to pay ordinary income taxes on its earnings. It is because of that sweeping importance of the question—even apart from its implications in other areas—that we sought certiorari in this case.[11]

Although the transaction may also raise some questions as to the tax treatment of the charity, its cornerstones are (1) the treatment of the stockholders' transfer of their stock as a "sale" (thereby giving them capital-gains treatment on their subsequent receipts); and (2) the deductibility of the earnings paid out by the operating company as "rent" (thereby eliminating the corporate tax and enhancing the amounts available for distribution to the former stockholders). In 1954, the Commissioner, launching an all-out attack on such transactions, ruled, *inter alia*, that the stock transfer was not a "sale" and that the remittances to the stockholders were taxable as ordinary income,[12] but his attack has met with only limited success in the lower courts. In the first case to be taken to a court of appeals, the facts were extreme and the court had

[11] Five additional cases from the Tax Court involving substantially identical transactions are now pending on appeal in the court below and are being held to await the decision of this case. *Anderson Dairy, Inc.* v. *Commissioner*, 39 T.C. 1027; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Singer* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,158; *Isis Windows, Inc.* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,176; *Stahl* v. *Commissioner*, 1963 P-H T.C. Mem. Dec. ¶ 63,201.

[12] Rev. Rul. 54-420, 1954-2 Cum. Bull. 128.

no difficulty in seeing through the form to the real nature of the transaction and accordingly held that it was not a "sale." *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7). Other taxpayers have been more careful, however, and by setting terms not so extreme as to make the device equally transparent—though in principle it remains the same—have persuaded other courts to explain away the *Kolkey* case as involving a "sham" transaction and to uphold their better camouflaged transactions as "sales."[13] The Commissioners' attack on the "rental" deduction has fared somewhat better, but has yet to meet with full success.[14]

This case is concerned only with whether the stockholders' receipts from such a transaction are to be accounted for as "capital gain." That term is defined simply as "gain from the sale or exchange of a capital asset". (§ 1222(3)).[15] There is here no dis-

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[13] *Commissioner* v. *Johnson*, 267 F. 2d 382 (C.A. 1); *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cls.); *Knapp Brothers Shoe Mfg. Co.* v. *United States*, 142 F. Supp. 899 (Ct. Cls.); cf. *Caldwell* v. *Campbell*, 218 F. 2d 567 (C.A. 5.) Of those, only the *Union Bank* case involved the same form of transaction used in this case. The *Johnson* and *Knapp Brothers* cases, like the *Kolkey* case itself, involved a variant of the transaction in use before the Revenue Act of 1950 (§ 301, 64 Stat. 948). The differences in the transactions, the effect of the Revenue Act of 1950, and why the transactions now take the indirect form they do, are explained in the petition (Pet. 26–30).

[14] Rental deduction disallowed: *Brekke* v. *Commissioner*, 40 T.C. 789. Rental deduction partially disallowed; *Royal Farms Dairy Co.* v. *Commissioner*, 40 T.C. 172; *Estate of Goldenberg* v. *Commissioner*, 1964 P-H T.C. Mem. Dec. ¶ 64,134. Rental deductions allowed: *Anderson Dairy*, *Isis Windows*, and *Stahl*, cited in note 11, *supra*.

[15] That has been the definition ever since special treatment was first accorded to capital gains in the Revenue Act of 1921 (§ 206(a)(1), 42 Stat. 232).

pute that respondents' stock in the old corporation was a "capital asset" and there is no claim that there was a taxable "exchange" of properties. The sole question, then, is whether the respondents' transfer of their stock to the Institute, on the terms agreed upon, was a "sale" of the stock within the meaning of that provision.

That there is *something* wrong with a transaction for which such extraordinary tax benefits are claimed seems apparent. The difficulty lies in identifying precisely what is wrong. The fact that the transaction usually involves a closely-held corporation the stockholders of which are also the managers, and that the usual arrangement is for them to continue to manage the business after the stock transfer, may at first be thought to be the objectionable feature. Upon reflection, however, it is evident that essentially the same thing could be accomplished, with the same vice, with a passive investment involving no "management" features at all (*e.g.*, stock in a widely-held corporation). Nor does the primary vice seem to lie in an "abuse" of the charity's tax-exemption, for if the initial question, "Whose income is it?", is properly answered, there ought to be no objection to according the normal exemption to the income *properly* attributed to the charity. It is generally only when the tax law permits income to be taxed to someone other than the one who realizes the real benefit from it that the opportunity to "abuse" a tax exemption arises, and that is the case here.

What in our view is wrong with the claimed "sale" characterization is both more precise and more funda-

mental than those objections. The basic difference between sales and transfers of property with a retained income interest, we will show, is that in "sales" the primary burden of future losses and the full benefit of future gains and profits are shifted to the transferee, while in reserved-income transfers the transferor remains dependent for payment upon, and thus shares in, the *future* gains and profits from the property. And if that is so, this transaction was not a sale for the simple reason that the burdens and benefits of the future gains and losses were in no way shifted from the respondents to the Institute. The respondents retained not only the full risk of future losses but also a right to a share of the benefits from the future gains, and their realization upon those benefits must be taxed to them as ordinary income, not as the proceeds from a "sale" of their stock.

I

THIS CASE IS EQUIVALENT, FOR PURPOSES OF ANALYSIS, TO A TRANSFER OF STOCK IN WHICH THE TRANSFEROR RETAINS THE RIGHT TO THE DIVIDENDS UP TO A STATED AMOUNT AND THE FURTHER RIGHT TO RECOVER THE STOCK, OR A SHARE OF ITS PROCEEDS, IF THE STATED AMOUNT HAS NOT BEEN RECEIVED BY A PRESCRIBED DATE

The difficulty the lower courts have had in dealing with these transactions is attributable to a complexity that tends to obscure the basic nature of the transaction. Only a part of the transaction is actually relevant to the question presented here, however, and the rest of the transaction can be ignored for present purposes.

The transaction in this case may be divided into the following three steps:

(1) The stockholders transferred their stock to the Institute in exchange for a "note" for $1,300,000 under which the Institute's liability was limited to remitting to the stockholders 90% of any amounts received by it on account of its ownership of the stock. The stockholders were also given the right to "foreclose" on the stock (or its equivalent), to recover the balance remaining due, if they were paid less than $250,000 in any two-year period.

(2) The Institute liquidated the original corporation, the effect of which was to substitute the corporate assets for the stock both as the source of the Institute's income and as the security for payment of the "note."

(3) The Institute transferred the corporate assets to Fortuna for a "rental" equal to 80% of the net profits.

The sole function of the second and third steps (taking the assets out of the corporation and "leasing" them for "rent") was to eliminate the corporation income tax that would have been due if the original corporation had been continued in existence. It was hoped that, under the lease arrangement, the profits remitted by Fortuna to the Institute would be deductible as "rent" by it yet not be taxable as "unrelated business income" to the Institute, and thus never be subjected to a corporation income tax. The success or failure of those steps to achieve that end is not, however, our present concern. We are concerned only with the effect of the initial step of the transaction—to wit, whether the stockholders' transfer of

their stock to the Institute on the terms of payment agreed upon constituted a "sale" of the stock, entitling the stockholders to account for their subsequent receipts from the Institute as capital gains. If it is concluded that that step in the transaction was not a "sale", then the further steps may have some bearing on the proper treatment of the stockholders' subsequent receipts (see Point V), but they are not germane to the "sale" question itself and may be ignored in considering that question.

To the extent that the terms of the purported sale of the stock to the Institute anticipated and took into account the subsequent steps, it is of course necessary, in order to close off the transaction after the first step, to assume a modification of those terms to make them consistent with the continued existence of the corporation. We will assume, accordingly, the following version of the transaction: The stockholders transfer their stock to the Institute in exchange for "notes" for $1,300,000 under which the Institute's liability is limited to remitting 90% of any *dividends* paid on the stock. The stock is pledged to secure payment of the note, and the stockholders are entitled to foreclose if the payments are less than $250,000 in any two-year period. It is further agreed that the Institute, as sole stockholder, will cause the corporation to distribute as dividends each year 100% of its after-tax income[16] and to continue to employ Clay Brown as general manager.

[16] The increased percentage of the business income to be distributed to the Institute is designed to compensate, so far as possible, for the fact that in that simplified version of the transaction the business income would remain subject to, and be diminished by, a corporation income tax.

It is in terms of that simplified version of the transaction that the main argument in this brief will be cast. The minor modification of the terms necessary to eliminate the further steps does not change the basic nature of the initial transaction. If the stockholders would not be entitled to capital gains treatment of their proceeds from the simplified version of the transaction, they are surely no better off because they also found what they believed was a way to eliminate the corporation income tax as well.

II

THE TRANSACTION MAKES NO ECONOMIC SENSE AND THE AMOUNT OF INCOME TO BE REMITTED MUST BE GREATER THAN THE PRESENTLY-REALIZABLE VALUE OF THE STOCK FOR THE TRANSACTION TO YIELD EVEN THE HOPED-FOR TAX ADVANTAGE

It was found below and vigorously asserted by respondents (see Br. in Opp. 4–5) that the transaction was the result of arm's-length bargaining, and the record leaves no room for doubt that neither party was motivated by any purpose to benefit the other and that each party sought only to advance its own interests. To examine the economic substance of such a transaction between persons dealing at arm's length, we may take an even simpler example which eliminates both the feature of continuing control of a closely-held corporation and, initially at least, the use of the charitable exemption (features which we assume are, if anything, unfavorable to respondents).

1. Assume that *A* owns as a passive investment a minority stock interest in a widely-held corporation,

the stock of which is traded over-the-counter. The current market value of *A*'s stock is $500,000 and its current dividend yield is $100,000, but the business is a young one of a speculative nature and the future of the stock, both in value and in yield, is relatively uncertain. *B*, a stranger, offers to buy the stock from *A* on the following terms: *B* will make no down payment and will not be personally liable but will give *A* a "note" secured by the stock in whatever total amount the parties agree upon as the "purchase price"; the stock and the note will be held by an escrow agent who will collect the dividends and remit them to *A* as payments on the note until the note is fully paid; if the payments are ever less than $100,000 a year, *A* may declare the balance due and, upon default, require the stock to be sold and the proceeds to be applied on the note.

Assuming the parties are untutored in tax law and bargain solely in economic terms, what "purchase price" might they be expected to agree upon? $500,000, $1,000,000, or $5,000,000? The answer, obviously, is that *A* will not agree to sell on those terms at any price. He is already entitled to receive all the dividends on the stock without limit and still retain full ownership of the stock. *B* is offering him neither anything more nor anything different but is simply asking him to impose a limit on his previously unlimited rights both to the stock and to its yield and to make a gratuitous transfer of the residual interest. Since *B* is to furnish nothing and risk nothing, there is nothing to bargain about, and however high the

"price" might be set it would still be less than a "reasonable" one on the terms offered and *A* would still be surrendering the ultimate ownership of the stock to *B* for nothing. In short, the offer is wholly meaningless in economic terms; it is but a request by *B* that *A* make a gift to him of a "remainder" interest in the stock after a reservation by *A* of whatever part of the future dividends he chooses to reserve to himself.

But now suppose that *B* is a reader of tax journals and points out to *A* (as the Institute pointed out to respondents) that, if he enters into the transaction, his subsequent receipts of the remitted dividends, though no different in amount than if he had kept the stock, will be treated as payments of the "purchase price" on a "sale" of the stock and thus be taxable only as capital gains. Being, as we will assume, in the 80% tax bracket, *A* readily grasps that if he can cut his tax rate on his annual receipts to 25% he will be well ahead in a few years even if it should cost him the ultimate ownership of the stock. If the dividends proved sufficient to pay the "price," such a "sale" of the stock for $1,000,000 would, for example, yield him $750,000 after taxes, whereas he would have only $575,000 after taxes if he held the stock for that period, reported the dividends as ordinary income, and then sold the stock for $500,000 in cash."[11] With a "price" of $2,000,000 the comparative

[11] We are assuming that *A*'s basis in the stock—often, as here, quite low—is zero. The after-tax yield from $1,000,000 of dividends taxable as ordinary income at an 80% rate would be $200,000; the yield from $500,000 of capital gains (from

after-tax yields would be $1,500,000 from the sale to *B* and $775,000 from a retention and subsequent cash sale.

With the parties having explored the tax advantages, what "price" might they now be expected to arrive at in their arm's-length "bargaining"? Since anyone else would serve *A*'s tax purposes as well as *B*, *B* still has no bargaining position—unless it be his "moral" claim to a share of the benefits as the "promoter" of the deal. Yet *A* is soon persuaded by the advice of the tax commentators [18] that the price should not be set too high lest the device, like that in *Kolkey* v. *Commissioner*, 254 F. 2d 51 (C.A. 7), be made transparent, and the same note of caution might also dissuade him from giving the windfall to, say, his son rather than to a stranger. On the other hand, the price must, as the commentators recognize,[19] be considerably greater than $500,000 to give *A* any benefit at all, since he could sell the stock over-the-counter for that price, be relieved of any further risk, and be entitled to capital-gains treatment without question. With those considerations providing the content for the so-called "bargaining"—and respondents, despite

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the sale at the end of the period) would be $375,000. If the amounts and rates used seem rather extreme, it only reflects the fact that, unless the "price" is set transparently high, the transaction is not generally feasible without also finding a way to eliminate the corporation tax and thus increase the annual cash yield.

[18] See articles cited in note 9, *supra*.

[19] See, *e.g.*, Moore and Dohan, *Sales, Churches and Monkeyshines*, 11 Tax L. Rev. 87, 100: "An abnormally high purchase price is economically essential to the transaction * * *."

their repeated assertions of the bargained nature of the transaction, have yet to say what other content there could be—we can only suppose that *A* would temper avarice with caution and somehow arrive at a "price" very considerably greater than the market price but not so much greater as to expose the transaction for what it is.

There is, however, a complication. A necessary corollary of *A*'s claim that the remitted dividends are payments of a "purchase price" to him for the "sale" of his stock would be that the dividends were taxable as ordinary income to *B*, applied by him to "purchase" the stock. While the difference in their tax brackets might still leave some room for maneuvering, that consequence would not only seriously diminish the over-all tax advantages but might also focus attention on the anomaly of taxing *B* on dividends which he merely collects and remits to *A* and which will total an amount far greater than any real economic benefit he receives (simply the possibility of the ultimate ownership of stock worth much less than the remitted-dividend "price"). It is for that reason that, as a practical matter, it becomes essential to use a tax-exempt entity as the "buyer" in such transactions. The tax exemption not only shields the dividends from any tax in the purchaser's hands but also obscures the anomalous implications of taxing the dividends to someone who merely collects and remits them to *A*.

The contribution that the use of the tax exemption makes to the transaction might, of course, be thought to give a tax-exempt "buyer" somewhat more bargaining power than an individual buyer would have. But

even that content of the "bargaining" is more illusory than real, since there are an almost unlimited number of possible tax-exempt buyers and it requires, indeed, only a certificate of incorporation for *A* to create one of his own. Such "bargaining" power as a tax-exempt buyer has must come, rather, only (1) from the facade of respectability which the participation of an established and well-reputed institution gives to the transaction and (2) from the "moral" claim that the initiating institution may be thought to have to share in the benefits from the plan which it worked out and first brought to *A*'s attention (see R. 173–174).

2. Pursuing the economic analysis of that transaction further, it is apparent that, if the price is anything more than $500,000, *A* can receive full payment, if at all, only by participating in the benefits of the *future* dividend yield or capital appreciation of the stock. His right of recourse against the stock itself affords him no assurance of payment, since by hypothesis its realizable cash value at the time of the "sale" is only $500,000. He thus not only continues to bear the full risk of loss from any future depreciation in the value of the stock but also to share in the benefits from any future income. His investment, in short, remains fully subject to exactly the same risks to which it was exposed before the transaction. What has been limited is not the risks to which the investment is exposed but only the benefits that will accrue to *A* should the investment turn out well.

Even if the price were set at $500,000—a price that could be explained only by *A*'s being truly motivated by charitable impulses—*A*'s receipt of that

amount would still remain fully subject to the risk of any future losses, and he would simply have eschewed any benefit from the future gains. While *A* would, it is true, have a right of recourse against stock that was initially worth that amount, he would have no margin of protection against fluctuations in the value of the stock and would thus bear the full burden of any future depreciation in its value.

There would be a significant change in the nature of the risk borne by *A* only if the price were in fact set at an amount substantially *less* than $500,000, in which event his right of recourse against stock initially worth that amount would give him a substantial margin of protection against future losses and thus provide him with a reasonable assurance of payment of his reduced claim independent of the future income-productivity of the stock. Such a price, however (as, indeed, would a price of $500,000), would constitute a gift of a very substantial equity in the stock to *B* and would thus be wholly inconsistent with our assumption (and respondents' claim) that the transaction was one at arm's length and not donatively motivated.

3. What the foregoing analysis shows is that any "bargaining" in such a transaction is economically meaningless and that, if the transaction is between persons dealing at arm's length and is not donatively motivated, the "price" must be presumed to be substantially in excess of the currently-realizable cash value of the stock. That conclusion requires, indeed, neither more nor less than the usual presumption that the price at which a transaction is concluded

between parties dealing at arms length will be a "reasonable" one—that is to say, the price that reasonable men, *dealing on the same terms,* would agree upon. And a necessary consequence of the price being greater than the presently-realizable cash value of the stock is that *A* will not only bear the full risk of any future losses but will also share in the benefit of any future income production or capital appreciation. What he receives, therefore, will represent, not the proceeds from his "cashing in" on the values accrued in the past (*ie.,* the present value of the stock), but the proceeds of his continued risk-bearing participation in the future gains and losses.

That, however, is all that we mean to establish by the foregoing analysis. We do not mean to deny that the transaction has "substance" or that it is "real" and not a "sham," for it may indeed have many "real" consequences even apart from the technical passage of legal title. One consequence, for example, is that *B* will thereafter have the voting rights in the stock. By far the most important consequence, however, is that *B* not only has legal title but may (if the dividends prove sufficient to pay the "price") end up with the full beneficial ownership of the stock as well. It is true that the transaction makes no economic sense except as a gift and, if concluded between strangers, can be explained only by the hoped-for tax benefits. But a gift of stock to one's son with a retained right to the dividends for a time (or up to a stated amount) plainly has "substance," and a transaction does not have any less "substance" (nor is it, we think, any less a gift) simply because it is motivated by tax con-

siderations rather than by personal affection. What is a "sham" about the transaction, if anything, is not the transaction itself (real enough in its consequences), but simply the "sale" label the parties so assiduously tried to attach to it.[20]

The question this case presents, then, is not whether the transaction has "substance," but whether the "substance" of the transaction is that of a "sale" or only that of a transfer of property with a retained right to income. It is that question of the proper legal characterization of the transaction for tax purposes, turning ultimately upon the meaning and purposes of the capital-gains provisions of the Code, to which we now turn.

III

A TRANSFER OF STOCK IN WHICH THE TRANSFEROR RECEIVES NOTHING BUT A RIGHT TO THE DIVIDENDS UP TO A STATED AMOUNT AND A RIGHT TO RECOVER THE STOCK IF THE AMOUNT IS NOT RECEIVED BY A PRESCRIBED DATE IS MERELY A TRANSFER OF PROPERTY WITH A RETAINED INCOME INTEREST AND NOT A SALE.

The respondents contend, and the courts below held, that the transaction in this case was a "sale" within the meaning of the capital-gains provisions. The government contends that it was merely a transfer of property with a retained right to income plus, in this instance, a further retained right to recover the prop-

[20] Cf. *Knetsch* v. *United States*, 364 U.S. 361, where the taxpayer was out of pocket 90,000 very real dollars, but the *characterization* of those dollars as "interest * * * on indebtedness" was illusory, and "*As a payment of interest*, the transaction was a sham" (p. 365, emphasis added).

erty itself, or a share of its proceeds, if the income remittances should fall behind a prescribed schedule.[21]

Inasmuch as the instruments were prepared by parties who wished to have the transaction treated as a sale for tax purposes, it is not surprising that they provide an elaborate facade of documentation using the words "sell," "Purchase Agreement," and the like throughout. It is wholly clear, however, that documentary terminology is not controlling, and that calling a transaction a "sale" in formal documents does not make it a sale for tax purposes. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252. "It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter." *Commissioner* v. *Duberstein*, 363 U.S. 278, 286.

If, then, formal terminology is not controlling, some more substantial basis for characterization must be found. By comparing those transactions which are clearly retained-income transfers with those which are clearly sales, we will show that the essential difference between them is the extent to which payment is assured independently of the future income produced by the property or of future changes in its value, from which it follows that this transaction, in

[21] Since the Institute had the right (though no obligation) to complete the payments out of its own funds, the transaction can be seen as also giving rise to an "option" in the Institute to buy the stock whenever the amount to be paid should be reduced sufficiently to make it advantageous for it to do so. The option was never exercised, however, and there is thus no question presented here as to what the effects of an exercise of the option would be.

which payment remained entirely dependent upon the future income from and value of the property, is not a sale. We will then show that that result is also required by the basic purpose of the capital-gains provisions to accord special treatment only to amounts which represent a realization upon the values accrued up to the time of the transfer, not those which represent a sharing in the gains or profits accruing from the asset after the transfer.

A. THE DIFFERENCE BETWEEN A TRANSFER OF PROPERTY WITH A RETAINED INCOME INTEREST AND A SALE OF THE PROPERTY SECURED BY THE PROPERTY ITSELF LIES IN THE DEGREE TO WHICH PAYMENT IS ASSURED INDEPENDENTLY OF THE FUTURE INCOME PRODUCED BY THE PROPERTY AND OF FUTURE CHANGES IN ITS VALUE

To show the essential difference between retained-income transfers and sales, we shall (1) establish that a transfer of stock on the transferee's promise merely to collect and remit the dividends for a time or up to a stated amount (*i.e.*, without, as here, any right of recourse against the stock itself) is plainly a retained-income transfer in which the dividends would be taxable to the transferor rather than the transferee; (2) establish that a transfer of stock on the transferee's payment of a substantial amount in cash and his promise to remit the dividends up to a stated amount, with the transferor having a right of recourse against the stock itself if he has not received payment by a day certain, is a "sale" in which the dividends remitted would be taxable to the transferee and not the transferor; and (3) then show that the only difference of substance between those two transactions is the reasonable assurance of ultimate payment, independent of the future dividend yield and

of at least substantial variations in the value of the stock, that the "down payment" in the second transaction affords. From that it will follow (4) that the presence in this case of the right to recover the property itself, or a share of its proceeds, if the dividends remitted do not reach a stated amount by a certain date—the only thing that differentiates it from the first case—does not make the transaction a sale, since that right by itself (*i.e.*, with no down payment) fails to provide any reasonable assurance of payment of the stated amount.

1. If *A*, owning rental property, conveyed a remainder interest to *B* and retained a life estate, no one would doubt that the rentals received by *A* during his life would be his income and would not be payments of a "purchase price" received by him from a "sale" of the property. To be sure, real property law would treat *A* as having an estate in land, but the result for tax purposes would be the same if *A* had purported to convey the land in fee simple to *B* on *B*'s promise (*i.e.*, a mere "contract" right) to collect and remit all the net rentals received during *A*'s lifetime.[22] That such differences are immaterial for tax purposes is, indeed, the most fundamental meaning of the doctrine that tax consequences turn upon the economic substance of transactions and not their legal form.[23]

[22] To eliminate any difficulties that might be introduced by *B*'s performance of services (see Point IV), it may be supposed that the property is to continue to be managed by the same real estate firm that managed it before the transfer, making *B*'s role purely passive.

[23] *E.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–267; *Burnet* v. *Harmel*, 287 U.S. 103, 110–111; cf. *Griffiths* v. *Helvering*, 308 U.S. 355; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331.

Nor, of course, would the results differ if *A* had reserved the right to the rentals for a fixed term of years rather than for a period measured by his life.

Similar transactions in intangible personal property rather than real estate are no different in principle, and if *A* transferred corporate stock to *B* subject to *B*'s promise to collect and remit the dividends for a stated term of years there would be no reason to characterize the transaction differently. Of course, many of such transactions would employ the mechanism of a trust, particularly if the amounts involved were large, and there the Code has provided explicit directions for taxation, at least in recent years. But if *A* felt he could rely on *B* (who might be, say, *A*'s son), the trust device might or might not commend itself to him for any of a number of reasons, and the tax results would be substantially the same. Nor, finally, would it make any difference if *B*'s promise were to pay over the dividends, not for a fixed term of years, but until the aggregate amount remitted reached a stated amount.

The inappropriateness of treating the yield from *A*'s retained income interest in such a transaction—*i.e.*, the annual dividends collected by *B* and paid over to him—as payments of a "purchase price" taxable to *A* only as capital gains is obvious enough. But even more incongruous would be the necessary corollary to that treatment—namely, taxing *B* on the full amount of the dividends collected by him notwithstanding his obligation to remit them to *A*. The duration or extent of the income reservation—*i.e.*, whether for 5 years, 20 years, or 50 years or until *A* has re-

ceived $100, $1,000, or $1,000,000—is solely a matter of *A*'s choice, depending simply upon how large an interest he wants to keep and how soon he wants the gift to *B* to become possessory. The total amount of the dividends collected by *B* and paid over to *A* is therefore wholly unrelated to the value of the stock, either at the time of the transfer or at the time *B*'s "remainder" becomes possessory. The ultimate receipt of the stock itself is, in turn, the only economic benefit that will ever accrue to *B* from the transaction. To tax him on the dividends, therefore, would be to tax him on amounts having no relation to any benefits realized by him. Whether or not the meaning of "income" as used in the Sixteenth Amendment requires it, the policy of the income-tax laws is to tax only values or benefits actually accruing to a taxpayer. Taxing *B* on 40 years' dividends because he will have the full beneficial ownership of the underlying stock at the end of that time could hardly be reconciled with that policy.

Without an elaborate facade of documentation and of "sale" terminology, not many taxpayers have had the hardihood to claim that a transfer of income-producing property in which the transferee undertakes merely to collect and remit the income for a time should be deemed a sale. When the argument was made in a few early cases, it was unhesitatingly rejected,[24] and since then there has been virtually no

[24] In *Bettendorf* v. *Commissioner*, 49 F. 2d 173 (C.A. 8), the owner of securities executed an instrument reciting that she "sold, transferred and delivered" the securities to the taxpayer, and the taxpayer "as a part consideration for such sale and transfer" agreed to collect the earnings and dividends and pay

further litigation of the matter in the lower courts—except of course in transactions, such as that involved here, in which the basic nature of the transaction is obscured by further complicating features. But while there is thus a sparsity of cases directly involving the simple form of retained-income transactions described above, any possible doubts about their treatment have been authoritatively resolved by this Court's decisions on analogous questions in the natural resources field.

While an outright sale of mineral interests qualifies for capital gains treatment, a purported sale of the mineral interests in exchange for a royalty from the

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them over to the seller during her life and then, her husband surviving, one half of the earnings and dividends to the "seller's" husband during his life. Thereafter there was to be no further obligation upon the taxpayer. The Commissioner, taking the "sale" at face value, asserted that dividends received were income of the taxpayer. The court rejected the Commissioner's position, and held that the income collected and remitted was taxable to the "seller" of the securities, not to the one who held legal title. "He paid nothing therefor, but agreed to the reservations attached to the gift." 49 F. 2d at 176. Accord: *Central Life Assur. Soc. Mut.* v. *Commissioner*, 51 F. 2d 939 (C.A. 8).

In *Fay* v. *Commissioner*, 34 B.T.A. 662, the taxpayer transferred securities to an institution which agreed to hold the securities, collect the income and transmit it to the taxpayer during his life, and then to his wife for her life. Thereafter the securities were to be devoted to the purposes of the institution. The taxpayer did not report income received from the institution, asserting that he had sold or exchanged his securities for an annuity, and had not yet recovered his cost. The Board of Tax Appeals rejected the taxpayer's claim, and upheld the Commissioner's asserted deficiency with respect to the remitted income. It remarked in language equally applicable to this case, "The grantor owned the securities transferred, and, as an incident of the ownership of those securities, was entitled

minerals produced is treated only as a transfer with a retained economic interest and the royalty payments are fully taxable as ordinary income (*Burnet* v. *Harmel*, 287 U.S. 103) and eligible for the depletion allowance (*Palmer* v. *Bender*, 287 U.S. 551). Most closely analogous is a "sale" of the minerals for a nominally fixed price, but with the "price" being payable only out of production (*e.g.*, a "sale" of all the minerals in place for $1 million payable out of ¼ of the first production). Because such an "oil production payment" is payable only if and when oil is produced, the seller

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to all the earnings or dividends therefrom. A transfer of the securities was made to the Institute for certain designated purposes, but the grantor never at any time parted with the right to receive the income." 34 B.T.A. at 667. Cf. also *Morton* v. *Commissioner*, 23 B.T.A. 930, affirmed *per curiam*, 61 F. 2d 1036 (C.A. 2).

An analogous question is posed by the estate-tax provision (§ 2036) including in the gross estate any property of which the decedent has made a transfer, except in "a bona fide sale for an adequate and full consideration in money's worth," in which he has retained a right to the income for a period that does not end before his death. For that purpose, the Tax Court had no difficulty in concluding that a transfer of stock "subject to your giving me the first dividends on these up to $15,000" was a reservation of income and not a sale." *Estate of Fry* v. *Commissioner*, 9 T.C. 503. In estate tax cases involving intra-family transfers, indeed, some courts have gone much further, finding that there was in effect a reservation of income when the amounts to be paid by the children (the transferees) coincided with the expected income yield from the securities even though the children were nominally personally liable for the payments, but those decisions would appear to be based on considerations peculiar to estate tax policies and to the problem of the recognition to be given to intra-family "obligations." See, *e.g.*, *Updike* v. *Commissioner*, 88 F. 2d 807 (C.A. 8); *Greene* v. *United States*, 237 F. 2d 848 (C.A. 7); but cf. *Lincoln* v. *United States*, 65 Ct. Cls. 198.

is held to have retained an economic interest in the future production and hence not to have made a "sale" of the property, notwithstanding that the transaction is effective to convey title as a matter of state law and that, once the pay-out is completed, full ownership of the minerals will vest in the "purchaser." *Thomas* v. *Perkins*, 301 U.S. 655.[25]

In their analysis those cases are also dispositive of the only discernible basis for the decisions below—to wit, that there was a completed transfer of the stock as a matter of property law, leaving the stockholders with no "property" interest in the stock but only "contract" rights to be paid certain amounts. The government made almost exactly the same argument in *Palmer* v. *Bender*, 287 U.S. 551, contending that an owner of a mineral lease who had transferred the lease to an oil company in exchange partly for an oil production payment and a royalty was not entitled to depletion because under State law the transfer was an absolute "assignment" and he no longer had a "property" interest in the minerals. Noting that it had been "elaborately argued * * * whether under Louisiana law the two instruments are assignments or subleases," this Court held that the "formal attributes of

[25] See also *Palmer* v. *Bender*, 287 U.S. 551. Compare *Anderson* v. *Helvering*, 310 U.S. 404, where there was a down payment of almost one-third of the price and the balance, with 6% interest, was payable either out of production or from a sale of the properties. Because the payment was not dependent solely upon production and the property itself furnished security (enhanced, it should be noted, by the substantial down payment), the Court, distinguishing *Perkins* on that ground, held the transaction to be a sale.

those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant" (pp. 555–556). The depletion allowance, the Court said, "does not depend upon * * * retention of ownership or any other particular form of legal interest in the mineral content of the land," but is available whenever "the taxpayer has acquired, by investment, any interest in the oil in place, and secures, *by any form of legal relationship*, income derived from the extraction of the oil" (p. 557, emphasis added). See also *Thomas* v. *Perkins*, 301 U.S. 655; *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308. While most of those cases involved the right to depletion, the treatment of the royalties as ordinary income is prerequisite to the allowance of depletion upon them. One can have ordinary income that is in some way dependent upon oil production without being entitled to depletion,[20] but one cannot be entitled to depletion without having ordinary income. And, if anything, "property" concepts are far more germane to depletion than they are to the characterization of receipts as capital gain or ordinary income.

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[20] The notion that, to have a depletable interest in the exhaustion of the mineral deposit, one must have a direct and immediate interest in the mineral itself (virtually in kind, as it were) goes far to explain the initial difficulty the Court had in allowing depletion based on a "net profits" interest—*i.e.*, a right to a share of the net profits from an oil production enterprise rather than to an amount measured directly by the gross proceeds from the sale of the oil. The Court first denied depletion on such an interest (*Helvering* v. *O'Donnell*, 303 U.S. 370;

If a transfer of a mineral interest with a retained right to a share of the proceeds of production up to a stated dollar amount is not a "sale," *a fortiori* a transfer of corporate stock with a retained right to the dividends (or a share of them) up to a stated dollar amount is not a "sale." The cases are identical in that the transferee's obligation is limited to remitting whatever income or production is realized and in that the transferor's interest in the property is to terminate entirely once the stated amount has been received. They differ only in that, in the oil-payment case, the transferee himself contributes materially (by drilling the well) to the production of the income that is remitted to the transferor, while, in the retained-dividends case, the transferee merely collects and remits dividend income to the production of which he has contributed nothing. The substantial contribution to the production of the income which is made by the transferee of the mineral interests gives at least some color to the contention that the income is earned by (and properly taxable to) him and is then paid

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Helvering v. *Elbe Oil Land Co.*, 303 U.S. 372) but later all but overruled those cases (*Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; see also *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308). Whether the earlier cases retain any vitality at all, the distinction there drawn between a gross-proceeds interest and a net-profits interest can be germane, if at all, only to the depletion question. While there might be some reason for limiting the special privilege of a percentage-depletion deduction to those with a "direct" economic interest in the oil itself, a right to a share of the future net profits from the enterprise is, if anything, much more obviously an *income* interest than is a right to a gross share of production.

over to the transferor as a payment of the "purchase price" for the interests;[27] a similar claim as to the transferee of stock who serves only as a conduit to collect and remit the dividends paid on the stock is not even colorable.

The treatment of the simple transactions we have thus far described is not, we believe, subject to serious doubt, and we do not anticipate that it will be challenged by respondents. Their claim to a different treatment here turns rather upon the presence of the further condition that, if the stated amount has not been received by a day certain, the transferors are entitled to cause the stock to be sold and to have the proceeds paid to them to make up the deficiency. Whether the presence of that additional condition is sufficient to convert the transaction into a sale is, as we have noted, the ultimate question to be answered.

2. To be contrasted with the transactions just described which clearly involve only a retention of a right to the income from the property are the transactions which equally clearly are sales. Certainly the model "sale" is a transfer of property in which the transferor completely severs his relationship to the property and receives full payment in cash. Yet credit transactions make up a large part of the universe of sales, and a transfer of property in exchange for a promise to pay a fixed amount, made by a solvent individual or entity from whom ultimate payment is reasonably assured, is equally a "sale." A

[27] For the possible significance of the transferee's contribution to the production of the income to be remitted, see Point IV, *infra*.

still further step is the elimination of the transferee's personal liability to pay the purchase price. Even though the transferee be not liable, the transaction would still qualify as a sale if the payment of the price were adequately secured by, say, the pledging of other assets or the personal liability of a solvent guarantor. The final instance is the case in which the transferee is not personally liable and no independent sources of payment are pledged but a substantial down payment is made and the property transferred is itself pledged to secure the payment of the balance of the purchase price. If the down payment is large enough so that the balance of the purchase price is substantially less than the value of the stock, the pledge of the stock without more provides reasonable assurance of payment and plainly qualifies the transaction as a sale.

Subject to the questions of degree implicit in those statements, we acknowledge that all of those transactions would properly be treated as "sales" and that the payments to the transferor would be taxable only as capital gains (except, of course, to the extent that they constituted interest). And if a transaction were otherwise a sale, it would obviously not make it any the less a sale if, to provide additional assurance of payment, it were further provided that any income from the property would be remitted to the transferor to be applied against the balance due until he had been fully paid. It follows, then, that if *A* transfers stock to *B* on *B*'s payment of a "substantial" amount in cash and his promise to remit the dividends until a stated further amount has been paid, and if *A*

in addition is entitled to cause the stock to be sold and to receive the balance due out of the proceeds if he has not been paid by a day certain, the transaction would qualify as a "sale".[28] Once again, however, that fails to dispose of this case since, although a fixed amount was stated as the "purchase price" and the assets transferred were pledged for its payment, the Institute was not personally liable, no down payment was made, and no other assets were pledged or guaranty given.

3. We may begin the analysis of the differences between those "clear" cases of retained-income transfers, on the one hand, and sales, on the other, by first noting those aspects which are plainly *not* the distinguishing features. The parties' labeling of the transaction as one or the other[29] is, as we already know, wholly irrelevant—however elaborate or expensively printed be the document in which the labels are used. The difference is not whether the income from the property is required to be or is in fact paid over to the transferor, since that may be equally true of sales. Nor can the difference be, as the Tax Court and the court of appeals seemed to think, whether there was a transfer of title or ultimately of the full beneficial ownership, for that is equally true, as we have seen, of transfers with a retained income interest. The fact that under certain circumstances the

[28] See Rev. Rul. 56-153, 1956-1 Cum. Bull. 166, and cases there cited.

[29] Or, as it is sometimes put, whether the parties "intended" the transaction—otherwise the same in terms of the substantive rights and duties created—to "be" a sale or not.

transferor may be entitled to recover the property transferred (at least in part) surely cannot, in and of itself, be what makes a transaction a sale. If in other respects the transferor's rights have the characteristics of a retained income interest, a further possibility of also recovering the property itself would prove, if anything, only that he has parted with less, not more, and thus make the transaction even less a sale.

What, then, is the difference between sales and transfers with income reserved? It is, we submit, simply the differing effects the transactions have upon the extent to which the transferor's receipts are *dependent* upon the future income yield from the property or upon future changes in its value. In short, the difference is risk-shifting. It requires no more than a brief analysis of the two classes of transactions in those terms to see the reality of that difference.

If *A* transfers stock to *B* subject to *B*'s undertaking to collect and remit the dividends for a stated time or up to a stated amount, what *A* ultimately receives—if, indeed, anything—is entirely dependent upon what income is produced by the stock in the future. He thus bears the entire risk whether the asset transferred will or will not prove to be productive in the future. That is evident from the simple fact that *B* has contributed nothing which could in any way insulate *A* from those risks, and the risks borne by *A* after the transaction are thus exactly the same, both in quality and in degree, as the risks borne by him before the transaction. By such a transfer, *A* merely *limits* his previously all-inclusive rights,

and the relationship of the limited rights he retains to the underlying asset remains unchanged. There is no "conversion" of his interest into something else or something different and hence there is no "sale".

All of the model "sale" transactions, in contrast, result in a significant change in the transferor's economic relationship to the assets and in the risks borne by him. In the purest example of a sale—a transfer for an immediate cash payment—the change is, of course, the most complete: *A* terminates his relationship to the asset and pockets its present cash value; *B* bears all the risks, and is entitled to all the benefits, of the future income productivity of the asset (or changes in its value). Only slightly less complete is the change when *A* receives the personal obligation of a solvent entity to pay a fixed amount. While the dividends from the stock may in fact be remitted to *A* in payment of the obligation, *A*'s right to payment is not dependent upon there being dividends; even if there were no dividends, *A* would still be entitled to collect the same amount from *B* or from any other assets of *B*'s. To be sure, *A* does have a risk that *B* will become insolvent, but, if *B* had substantial other assets or income-producing capacity at the time of the transfer, that is a very different risk from that previously borne by *A* as the owner of the stock. The change is least complete, but still significant, when there is a substantial down payment but *B* is not personally liable and the payment of the balance of the purchase price is secured only by a pledge of the stock itself. Since *A* has a prior right to be paid the balance of the purchase price before *B* re-

covers his investment—*i.e.*, the down payment— it is *B*'s investment that bears the primary exposure to the risks of future gains or losses. Bearing the primary risks, he is entitled to the correlative benefits and, if the down payment is large enough to cause a significant shifting of the risks, he has the necessary economic bargaining power to insist upon a purchase price approximating that which would be arrived at in a cash sale. With an immediate payment of a substantial part of the purchase price and a pledge of the stock to secure payment of the balance, therefore, *A* has recourse for the payment of the balance of the price against assets (the stock itself) worth substantially more than the amount of his claim. While the transaction would also normally provide for the remittance of the interim dividends, the effect of the "cushion" afforded by the down payment is that *A* is no longer *dependent* upon the dividends for payment. Even if there should be no dividends, *A* would be entitled to collect the same amount by foreclosing on the pledged stock, an amount which there is a reasonable assurance the stock, having initially been worth substantially more than the balance due, will yield.

The relevance to characterization as a "sale" of the shifting of the risk of future losses and the benefit of future gains that occurs in the latter class of transactions is plain. By such a transaction, *A* gives up his "equity" interest in the asset—bearing the risks and benefitting from the gains—and becomes a mere "creditor" with an adequately secured claim in a fixed amount. Even though his only recourse be

against the very asset he transferred (*i.e.*, where there is a substantial down payment but no personal liability), he no longer has a risk-bearing, income-sharing interest "in" the asset but only a creditor's claim "against" it. That basic change in the nature of his relationship to the asset—not present, as we have seen, in retained-income transfers—is sufficient to treat him as having converted his former interest into something else. And it is just such a "conversion" of one's interest in an asset that is the essence of a "sale" and that makes it an appropriate occasion to require the seller to account for the gains and losses accrued from his investment up to that time.

4. If we are correct as to why the clear cases of sales are sales and why the clear cases of transfers with income reserved are not, there can be no difficulty in properly classifying the transaction in this case. While respondents had a right not only to a remittance of the dividends up to a stated amount but also (unlike the clear cases of retained-income transfers) a right to recover the stock, or a share of its proceeds, if the stated amount was not received by a prescribed time, the addition of the latter right is relevant only to the extent that it does in fact operate to afford a reasonable assurance of ultimate payment regardless of the future dividend yield or of future changes in the value of the stock. That is true when there is a down payment which is substantial in relation to the "price" to be paid, since the very fact of the down payment, and the risk-shifting that results from it, establishes that the parties have bargained on the economic terms normal to the market

place and, hence, that the "price" represents the present value of the stock. A right of recourse against the stock, worth the full price, for the payment of only a fraction of the price thus affords reasonable assurance of payment. Here, however, there was no down payment,[30] and since there is no claim that the transaction was donatively motivated we need not even reach the question whether, if the "price" were substantially *lower* than the present value of the stock even though there was no down payment—with there being, in effect, a gift of the substantial equity interest which a "buyer" normally acquires with a down payment—the transaction would qualify as a "sale."

The parties to the transaction in this case, as respondents have consistently asserted, dealt at arm's length with each other, each seeking to serve his own ends. In such a transaction—*i.e.*, a transaction between strangers in which the transferee furnishes nothing—either the amount of the dividends to be remitted to the transferor must be substantially greater that the present value of the stock or the transferor must be a fool, an explanation not to be presumed. Thus the courts below were, if anything, guilty of understatement in their acknowledgement that the

[30] There was, to be sure, an immediate distribution to respondents of $5,000 out of the corporate assets, but that came out of the very property transferred, not from the transferee, and thus in no way shifted the risks. The same thing would be true, of course, of a "down payment" made by a transferee which he is entitled to recover from the assets *prior* to full payment of the tranferor's claim. A down payment serves to shift the risk only when the "equity" thereby acquired by the transferee is *subordinated* to the transferor's claim.

amounts to be remitted may have been "somewhat higher" (R. 62) or were "probably greater" (R. 295) than the amount respondents could have realized from their stock in any other kind of transaction. And if the amounts to be remitted are greater than the present value of the stock, then it is obvious that the right of recourse against the stock in no way removes the transferor's continued dependence upon future income production or future changes in the value of the stock for payment of the stated amounts. Indeed, all that the addition of that right means is that the transferor has retained not only the benefit of future dividends but also the benefit of any future appreciation in the value of the stock as well.

In such a transaction, in short, the transferor retains not only the full risk of future losses but also at least a share of the benefit of future gains (either from dividends or from capital appreciation). He remains fully subject to exactly the same risks he bore before and has simply imposed an upper limit (presumably in the hopes of thereby realizing some tax advantage) on his right to the future benefits. There has been no conversion of his interest, through risk-shifting, from an "equity" interest in the stock to a "creditor's" claim against it, and what he has left after the transaction is but a lesser part of what he had before. Such a transaction is not a "sale." It is but a gift of a contingent future interest[21] in the

[21] We are speaking, of course, of a case in which 100% of the dividends are to be remitted. Here the Institute was not only given the possibility of ultimate beneficial ownership but also an interim right to 10% of the dividends.

stock—albeit one motivated solely by a hoped-for tax benefit rather than charitable impulses—and a retention of everything else. The dividends remitted to the transferor pursuant to that retained right, it follows, are taxable to the transferor, not the transferee, and wholly fail to qualify for capital gains treatment.[22]

5. It hardly needs adding that whether any given down payment or pledge of other assets or of personal liability is sufficient to qualify a particular transaction as a sale is, of course, a question of degree, requiring a judgment based upon all the circumstances bearing on the extent to which there has been a significant shift of the risks. The judgment would have to take into account, for example, not only the absolute amount of the down payment or its relationship to the price but also such factors as the speculative or stable nature of the asset: the down payment required to make a transfer of stock in a corporation owning only government bonds a sale might be quite different from that required if the corporation is a new one just embarking on the development of a new product. None of those questions are faced in this case, however, for the simple fact is that the Institute furnished nothing at all and there was thus *no* risk-shifting. For that reason, the difference here is not one of degree but is, in fact, one of kind. The question is simply whether there can be a "sale" where

[22] The effect of a later exercise by the transferor of his right, upon certain events, to have the stock sold and to receive the proceeds is, of course, an entirely different question. Although there was such a final disposition of the property in this case in 1958, that year is not before the Court.

there is no risk-shifting at all and the transferor remains *entirely* dependent for payment upon the future income yield from, or future changes in the value of, the very property transferred. The answer to that question, we submit, cannot be in doubt.

B. THE PURPOSE OF THE CAPITAL-GAINS PROVISIONS TO AFFORD SPECIAL TREATMENT ONLY TO AMOUNTS WHICH REPRESENT A REALIZATION UPON VALUES ACCRUED UP TO THE TIME OF THE TRANSFER, AND NOT TO AMOUNTS WHICH REPRESENT A SHARING IN THE GAINS OR PROFITS ACCRUING FROM THE PROPERTY AFTER THE TRANSFER, REQUIRES THAT THE TRANSACTION IN THIS CASE NOT BE TREATED AS A SALE

The capital-gains provisions "must not be so broadly applied as to defeat rather than further the purpose of Congress," and this Court "has always construed narrowly" the definitional provisions in order to prevent a frustration of that purpose. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51–52; see also, *e.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Burnet* v. *Harmel*, 287 U.S. 103. The difficulty comes, of course, in knowing what that purpose is, for in many circumstances the purpose may be obscure. But however much doubt there may be about the policies of the capital-gains provisions in other respects, about one thing there can, we submit, be no doubt: that Congress never intended to accord capital-gains treatment to anything more than a realization upon the *present* value of an asset at the time of its transfer, and that any application of the provisions that permits the fruits of a continued sharing in the *future* gains and profits produced by the asset to be taxed

only as capital gains is basically offensive to the purposes of those provisions.

Special tax treatment was first accorded to capital gains—defined in terms substantially identical to the present law [33]—by the Revenue Act of 1921. The reason given for the special treatment was that (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11):

> The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum * * * in the year in which the profit is realized.

The only thing that was intended to be given preferential treatment, then, was the realization, by a sale, of "gains and profits earned over a series of years" in the past and thus reflected in the present value of the asset *at the time of the sale.* It was only that value that was in any danger of being realized "as a lump sum" and it was therefore only the realization on that value that was meant to be given special treatment. To allow the yield from a retained right to share in the future gains and profits produced by the asset to be taxed only as capital gain would therefore be directly opposed to the explicitly stated purpose of Congress.

The same limitation is implicit in the requirement of the statute that, for capital-gains treatment, the asset must have been held for a stated period (now,

[33] "The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921." § 206(a)(1), 42 Stat. 232.

six months) prior to its "sale," a requirement that makes sense only if the gain realized and accorded capital-gains treatment represents values that accrued during that period—*i.e.*, up to, but not after, the date of the sale. The conclusion is equally dictated by this Court's repeated recognition that the purpose of the capital-gains provisions was to afford relief from the application of the steeply progressive ordinary rates to the realization in a single year of values that may have accrued over many years in the past. *E.g., Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265; *Burnet* v. *Harmel*, 287 U.S. 103. That purpose obviously does not warrant extending capital-gains treatment to annual receipts derived from a continuing risk-bearing participation in the future income from the asset.

In this case, as we have shown, the stockholders retained not only the full risk of future losses but also a right to a share of the benefits from future gains, either from future income production or from future capital appreciation. They chose to continue to bear those risks in the hopes that their receipts would ultimately be greater than the amount they could have realized by "cashing in" on the present value of the stock. To allow them both to have the fruits of their continued risk-bearing and yet to receive the preferential treatment accorded to capital gains—in short, to hold that this transaction was a "sale"—would thus be directly contrary to the purpose of the statute.

IV

TRANSACTIONS IN WHICH THE TRANSFEREE CONTRIBUTES TO THE PRODUCTION OF THE INCOME TO BE REMITTED ARE DISTINGUISHABLE AND THE PROBLEMS THEY PRESENT NEED NOT NOW BE RESOLVED

In this case, and in the other transactions we have analyzed, the transferee was to perform a purely passive role, merely collecting and remitting the income produced by the asset without in any way contributing to its production. In transactions in which the transferee, either by performing services or making an additional investment, is to contribute to the production of the income to be remitted, there is an additional element which may, at least in some circumstances, as will show, justify a different result.

Because the contribution of the transferee to the production of the income may at least sometimes justify a different result, the presence of such a contribution by the transferee provides a sufficient distinction, for present purposes, between this case and the lower court decisions which, in conflict with the Second Circuit, accord capital gains treatment to patent royalties. Lest respondents seek to draw comfort from those cases, however, we will go on to show that those cases were in any event wrongly decided and are, in fact, directly contrary to the "economic interest" principle established by this Court's decisions in the oil-royalty cases.

1. Suppose that *A* transfers farm land to *B* on *B*'s agreement to farm the land and remit all of the income to *A* until *A* has received a stated amount,

whereupon *A*'s interest is to terminate, and that *A* also has the right to "foreclose" on the property for the balance due if the remittances fall behind a prescribed schedule. One way of analyzing that transaction is to see *A* as simply buying *B*'s services for the period of the "pay-out" in exchange for the transfer of the full beneficial ownership of the land at the end of that period: *A* would be taxed on all of the remitted income subject to a deduction for the "wages" paid (*i.e.*, the land[34]); *B* would receive the land itself as "compensation" earned by his services, presumably taxable, if he is on the cash basis, in the year when the pay-out is completed.[35] Another way to see the transaction (we do not say it would be a practical solution) is as a retention of a term interest and a "sale" of the "remainder." Assume that in a normal crop-sharing arrangement, involving no disposition of the land, the income would have been divided 60% to *A* and 40% to *B*. If so, the income during the pay-out period could be seen as attributable 60% to *A*'s investment in the land and 40% to *B*'s services (*i.e.*, in the normal proportions) and be taxed accordingly, with *B*'s 40% of the income then being remitted to *A* in payment for the "remainder" interest in the land—*i.e.*,

[34] There is an unresolved question whether, if appreciated property is used to pay for services, the deduction should be limited to the basis of the property or whether there is a "realization" of the appreciated value, taxable as capital gain but entitling the transferor to an ordinary deduction for the full value of the property.

[35] The receipt might qualify for income-averaging under § 1301, either before or after its amendment by the Revenue Act of 1964, § 232(a), 78 Stat. 19.

for its full beneficial ownership after the pay-out is completed.

Yet it would also be plausible to treat the transaction as a whole as a "sale," particularly if *B* had committed himself to continue to farm the land until the pay-out is completed. By furnishing valuable services but subordinating his right to any part of the income until *A* has been fully paid, *B* has greatly increased the assurance that *A* will receive the stated amount and has shifted to himself the primary risks and benefits accruing from the possibility that the income yield will be more or less than anticipated. He has, in short, "underwritten" by the investment of his services the receipt of the stated amount by *A*. Particularly in view of the relatively stable nature of the enterprise—the substantial certainty that with *B*'s contributed services, the farm *will* eventually produce enough income to pay off *A*—that shifting of the risk may be sufficient to warrant treating the whole transaction as a sale, taxing all of the income to *B* and according capital gains treatment to *A*. The very fact of the shift of the primary risk, it should be noted, gives *B* an economic bargaining position, and, since he must invest valuable services yet defer any realization until *A* has been paid, he would presumably be unwilling to agree to a "price" greater than he thought the property worth.[36]

[36] The supposed transaction, it will be seen, is analogous to that involved in *Thomas* v. *Perkins* (301 U.S. 655) mentioned earlier (pp. 44–49, supra), where *A* transferred mineral interests to *B* on *B*'s undertaking to develop the property (*i.e.*, drill a well) and to pay over to *A* a fraction of any oil pro-

The point is not that a contribution by the transferee to the production of the income (even a major one) will *always* make the transaction a sale,[37] but only that it is itself an important factor in appraising the extent to which there has in fact been a sufficient shifting of the risks to qualify the transaction as a sale.

To be distinguished from the kind of risk-*shifting* that occurs in the first example is the mere risk-*sharing* that occurs when *A* furnishes an asset which *B* is to make productive subject to an agreement to share the income produced over the entire life of the asset. Suppose, for example, that *A* owns only a 20-year leasehold in farm land which he conveys to *B* on *B*'s agreement to farm the land and to remit 60% of the income produced over the entire

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duced until *A* had received a stated amount, whereupon *A*'s interest was to terminate. There, the Court held that no part of the transaction was a sale and treated *A*'s entire receipts as simply the proceeds of a retained income interest, despite the major investment made by *B* in producing the income paid over to *A*. That case can be distinguished, however, on the ground that, because it remained wholly speculative and contingent whether *any* income would be produced, *B*'s investment in drilling the well in no way insulated *A* from the risks of production or non-production. Instead of "cashing in" on the value of the mineral interests by an outright sale, *A* kept an interest in whatever oil might be produced and thus "gambled" on oil being discovered, and it can hardly be supposed that the amount to be paid him when the gamble paid off would bear any relationship to the realizable value of the property at the time of the transfer.

[37] For an intermediate case posing a much more difficult problem of characterization, see *Vermont Transit Co.* v. *Commissioner*, 19 T.C. 1040, affirmed, 218 F. 2d 468 (C.A. 2); but cf. *Crabtree* v. *Commissioner*, 22 T.C. 61, affirmed *per curiam*, 221 F. 2d 807 (C.A. 2).

20-year term. *B*, to be sure, does put an investment at risk in the enterprise, but it is not one that insulates *A* from the same degree of risk: *A* and *B* have merely shared the investment in, the risks of, and the income from, the venture in the same proportions. The transaction amounts simply to a joint undertaking in an income-producing activity—with each contributing a different factor of production, one the land and one the labor—and the income should obviously be taxed 60% to *A* and 40% to *B*. Nor, of course, should it make a difference whether *A*'s share is defined as a percentage of gross income, as a percentage of net income, or as a fixed amount per bushel of wheat sold. In either case, what he receives is entirely dependent upon what is produced and in no way reflects the value of his leasehold on the date of the transfer nor, hence, what he might have realized by "cashing in" on that value and being relieved of any further risks.

The case last supposed, it may be seen, is an exact parallel to *A*'s transfer of a patent to *B* on *B*'s agreement to pay *A* a "royalty" equal to a stated percentage either of the gross proceeds or of the net income from the manufacture and sale of the patented item over the life of the patent. Even though in property law terms there may have been a completed "transfer" of the patent—just as there may have been of the leasehold in the preceding case—the arrangement results simply in a joint undertaking in the exploitation of the invention: *A* furnishes the patent; *B*, the manufacturing and the selling; and *A* and *B* then

share the income in proportion to their respective contributions to its production and to the risks they each continue to bear. While the *value* of *A*'s royalty contract on the date of the transfer presumably reflects the then value of the patent, whether the exploitation of the patent will prove successful and, if so, to what extent is entirely speculative, and the amounts actually remitted to *A* when the venture does prove successful obviously bear no relationship to the realizable value of the patent at the time of the transfer. The receipts, in short, in no way represent a realization upon "gains and profits earned over a series of years [prior to the sale]" (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11)—they are rather profits accruing after the transfer from *A*'s continued risk-bearing participation in the fruits of the exploitation of the patent—and are thus plainly not the kind of gain that Congress meant to qualify for the special treatment accorded capital gains.

Yet among the courts of appeals, the Second Circuit stands virtually alone in analyzing patent-royalty cases in those economic terms, an analysis which, of course, unavoidably led it to the conclusion that there was no "sale" and that the proceeds of the patentee's continuing interest in the successful exploitation of the patent were taxable as ordinary income. *Bloch* v. *United States*, 200 F. 2d 63. Most of the other lower courts have asked only whether, in property law terms, there was a complete transfer of all the "property" interests in the patent, seeking to find the answer in the distinction between an "assignment"

and a "license" of a patent drawn by this Court years ago in *Waterman* v. *Mackenzie*, 138 U.S. 252, in order to determine which party was entitled to maintain a suit for an infringement of the patent. Finding that there was an "assignment" rather than a mere "license"—finding, that is, that *B* could sue for patent infringement—the courts have merely assumed without discussion that that answered the tax question and have accordingly taxed the royalties only as capital gains.[38] No doubt the failure of analysis is attributable largely to the fact that the cases were generally argued by parties, including the government, in the same property-law terms in which they were decided.[39] But while that may make the error understandable—and, because the real issue was never argued, weaken the authority of those cases—the error is, we think, no less plain. Indeed, the cases according capital gains treatment to patent royalties are not only wrong in principle but they are, we submit, squarely in conflict with this Court's decisions, discussed above at pp. 44–49, holding oil royalties to be taxable as ordinary income, for there is simply no meaningful distinction to be drawn between the royalties received by a transferor

[38] *E.g.*, *Commissioner* v. *Celanese Corp.*, 140 F. 2d 339 (C.A. D.C.); *Allen* v. *Werner*, 190 F. 2d 840 (C.A. 5); *Watson* v. *United States*, 222 F. 2d 689 (C.A. 10); *Massey* v. *United States*, 226 F. 2d 724 (C.A. 7); *United States* v. *Carruthers*, 219 F. 2d 21 (C.A. 9); *Rollman* v. *Commissioner*, 244 F. 2d 634 (C.A. 4); *Kronner* v. *United States*, 110 F. Supp 730 (Ct. Cls.).

[39] If the royalty aspect was mentioned at all, it was referred to simply as one of the "factors"—together with, *e.g.*, retained powers of control—which indicated that the particular transfer was "really" a "license" rather than an "assignment."

of mineral interests and those received by a transferor of patent interests.

While the treatment of patent royalties has now been resolved by statute as to certain patent transfers,[40] the question remains viable as to some of the most common, among them transfers to controlled corporations, probably the class with the most important tax implications.[41] Essentially the same question is presented, moreover, by transfers of a franchise subject to a royalty, the litigation over which, although similarly becoming enmeshed in property concepts, has produced results considerably less uniform than the patent-royalty cases.[42] Another prevalent practice which presents substantially the same question is the transfer of land to a cemetery association in exchange for a percentage (often, 50% or more) of the proceeds of the association's resale of the land as burial lots, but there the litigation to date has

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[40] 1954 Code § 1235; 1939 Code § 117(q), added by the Act of June 29, 1956, 70 Stat. 404. See *United States* v. *Zacks*, 375 U.S. 59. The statute accords capital-gains treatment to the transfers to which it applies, but it generally applies only to transfers by the inventor and then only if the transfer is to an unrelated party.

[41] In 1958, however, the Internal Revenue Service, faced with a mounting tide of adverse decisions, was forced to cease litigating the question, at least for the time being. Rev. Rul. 58–353, 1958–2 Cum. Bull. 408.

[42] See *Dairy Queen of Oklahoma* v. *Commissioner*, 250 F. 2d 503 (C.A. 10) (both lump sum payment and royalties are capital gain); *Gowdey* v. *Commissioner*, 307 F. 2d 816 (C.A. 4) (only lump sum is capital gain); *Moberg* v. *Commissioner*, 305 F. 2d 800 (C.A. 5) (same); *Moberg* v. *Commissioner*, 310 F. 2d 782 (C.A. 9) (neither lump sum nor royalties capital gain).

centered on the exempt status of the association[43] rather than the tax treatment of the transferor.[44]

Despite the continuing importance of the question and what seems to us the clear error of the cases according capital-gains treatment to patent royalties, however, it is not a question that need be reached in this case. In such transactions, the transferee does make a major contribution to the production of the income to be remitted and that is, as we have shown, an important difference which, in some contexts at least, might justify a different result. Even in the patent-royalty cases, that factor at least gives some color to the claim that the income is "earned" by the transferee and ought to be taxed to him, and it may be doubted whether even a court which accorded capital-gains treatment to patent royalties would be willing to grant the same boon to one who transferred stock on the transferee's undertaking merely to collect and remit the dividends for, say, 17 years. To that extent at least the cases have been influenced by the transferee's contribution to the production of the income, and, since any such contribution is wholly

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[43] See *Commissioner* v. *Kensico Cemetery*, 96 F. 2d 594 (C.A. 2); *Forest Lawn Memorial Park* v. *Commissioner*, 45 B.T.A. 1091.

[44] But see *Sherwood Memorial Gardens, Inc.* v. *Commissioner*, 42 T.C. 211, where a somewhat more complicated transaction was treated consistently with our analysis here. For the extent to which the promoters' hopes of realizing the proceeds from burial-lot sales as capital gains may account for the high-pressure salesmanship practiced by the rapidly mushrooming "non-profit" cemetery associations, see Mitford, *The American Way of Death* (1963), particularly Chapter 9, "God's Little Million-Dollar Acre."

lacking in the case, the Court may fairly confine its decision to that circumstance and leave to another day the treatment of patent royalties and the like.

V

NO ISSUE HAS YET BEEN RAISED IN THIS CASE, OR CONSIDERED BY THE COURTS BELOW, AS TO THE EFFECT UPON RESPONDENTS OF THE SUBSE NT STEPS OF THE TRANSACTION (THE LIQUIDATION OF THE CORPORATION AND THE TRANSFER OF ITS ASSETS TO A NEW CORPORATION) IF THE INITIAL TRANSFER OF THEIR STOCK WAS NOT A "SALE," AND NO SUCH ISSUE IS NOW BEFORE THE COURT OR NEED BE DECIDED

We have shown that, if the transaction in this case had been limited to a transfer of the stock to the Institute on its promise to remit 90% of the dividends up to $1,300,000, with the respondents having the right to recover the stock (or a share of its proceeds) if less than $250,000 was received in any two-year period, the transaction would not qualify as a "sale" and respondents' annual receipts of the remitted dividends would thus not be taxable as the proceeds of a sale. That the purported sale of the stock was in fact followed by the Institute's liquidation of the corporation and "lease" of its assets to a new operating company can in no way affect that conclusion, and we do not believe respondents will contend otherwise. If the initial transaction was not a "sale," however, it is at least possible that the subsequent steps would have some independent consequences affecting the proper tax treatment of respondents' receipts. Those, however, are wholly different ques-

tions from the question decided by the courts below and the question brought here for review. They need not—indeed, ought not—be explored here for the first time, and if the Court agrees with us that the first step in the transaction was not a "sale" the proper course would be to remand the case to the Tax Court for a consideration of the effect, if any, of the subsequent steps. Indeed, as yet respondents have made no claim that the subsequent steps would affect the treatment of their receipts if there was no "sale" of their stock, so that any consideration of those questions now would be wholly premature. We shall, accordingly, merely indicate the nature of some of the possible questions that might be raised by the subsequent steps and in no way attempt to answer them.

1. There are in the tax law many issues as to the proper tax treatment of shareholders even when they do not purport to "sell" their stock to third parties (*e.g.*, whether their dividends are out of "earnings and profits.") It should therefore not be surprising that a holding that respondents' transfer of their stock to the Institute was not a "sale" would not automatically determine the proper treatment of all their subsequent receipts or the effect of the subsequent steps in the transaction.[45] The questions as to the

[45] For example, even in the simple case in which *A* transfers stock to *B* solely for *B*'s promise to remit the dividends for 20 years, a holding that the transaction is not a "sale" and that the dividends remain "taxable" to *A* would not in itself determine the proper tax treatment of the subsequent dividends, which would turn upon whether they were out of "earnings and profits" of the corporation. The further questions discussed here bear the same relationship to the "sale" question.

effect of the subsequent steps are, indeed, largely the same questions that would have been raised if respondents had not first purported to sell their stock to the Institute but had themselves liquidated the old corporation and transferred its assets to Fortuna on the same terms.

If respondents had themselves liquidated the old corporation and "leased" its assets to Fortuna for 80% of Fortuna's net profits (*i.e.*, the same transaction but omitting the transfer of the stock to the Institute[46]), there would have been presented a number of questions the primary thrust of which would be whether the profits remitted by Fortuna as "rentals" would escape the corporation income tax, but which would also affect the treatment of the individual stockholders. The first question would be whether the liquidation and transfer of the assets to a new corporation qualified as a tax-free "reorganization"—a question which might depend, for example, upon whether respondents' "lease" rights to 80% of Fortuna's net profits should be treated as a "stock" interest in Fortuna and whether the "voting" rights of respondents' attorneys (to whom all the voting stock was issued) could be attributed to respondents (see § 368). If there was a "reorganization," the liquidation would not be taxable; the old corporation's basis and its earnings and profits would be carried over to Fortuna; the "rental" payments would be dividends not deductible by Fortuna; and the taxability of respond-

[46] For simplicity, we are also ignoring the "sale" of the current assets to Fortuna.

ents' "rental" receipts, treated as dividends, would depend upon the earnings and profits of Fortuna, so determined (see §§ 301, 316, 354, 362, 381). If there was not a "reorganization," the liquidation of the old corporation would be a taxable event and respondents would be subject to a capital-gains tax, in the year of the liquidation, on a gain measured by the value of the corporate assets—a taxable event, it should be noted, very different from the stock "sale" claimed by respondents here, both in principle and in the measurement of the gain (see § 331). Even though there was no reorganization and the liquidation itself was taxable, however, there would remain essentially the same question whether the further "lease" of the assets to Fortuna for 80% of its net profits should be treated as giving rise to a "stock" interest in Fortuna on "thin capitalization" principles,[47] causing the "rental" payments to be treated as dividends, non-deductible by Fortuna and taxable to respondents on the basis of Fortuna's earnings and profits (though in that event there would be no carry-over of the old corporation's tax attributes) (see also § 351). If, finally, there was a taxable liquidation and the "lease" of the assets was accounted for as a true lease, respondents would presumably be entitled to claim depreciation deductions for the "leased" assets based on the value of the assets at which they were taxed on the liquidation.

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[47] See, e.g., *Gooding Amusement Co.* v. *Commissioner*, 23 T.C. 408, affirmed, 236 F. 2d 159 (C.A. 6); *Farley Realty Co.* v. *Commissioner*, 279 F. 2d 701 (C.A. 2); Surrey & Warren, *Federal Income Taxation*, pp. 1187–1204 (1960).

In the actual "combined" transaction—(1) a purported "sale" of the stock to the Institute followed by (2) the Institute's liquidation of the corporation and transfer of the assets to Fortuna—the problems presented by the subsequent steps (if the first step is held not to be a "sale") remain essentially unchanged. And it may yet be necessary to answer at least some of them (*i.e.*, on remand) to determine the tax character of the respondents' subsequent receipts—*e.g.*, whether they are "dividends" (and, if so, by whose earnings and profits their tax treatment is governed) or "rents" (and, if so, what basis respondents may use for depreciation). The only question that the combination of the several steps would seem significantly to affect is the question whether, if there was not a reorganization, the liquidation itself was taxable (see § 332) and, if so, to whom, the Institute (in which event its tax exemption would eliminate the tax) or the respondents (in which event they should have paid a capital-gains tax in 1953, the year of the liquidation). That question is a complex and difficult one, but since the Commissioner did not assert a tax against respondents on the liquidation—and since we may safely assume that respondents will not claim that it was taxable to them—the question is not presented in this case.

2. That brief analysis of the nature of the questions presented by the subsequent steps—none of which have yet been raised by the parties or considered by the courts below—is enough to show that they are in fact entirely separate from the question presented

here whether the initial step was a "sale." It also, however, has a second significance which, while not immediately relevant, may contribute to a fuller understanding of the transaction: to wit, it permits a reappraisal of the role actually played in such transactions by the tax exemption of the purported "buyer."

Inasmuch as the hoped-for elimination of the corporation income tax depends ultimately upon whether Fortuna may deduct the purported "rental" payments—and since, as we have shown, that question would be the same with or without the initial transfer of the stock to the Institute—the tax exemption does not itself contribute to the accomplishment of that object of the transaction. Its primary contribution is rather one that is dependent upon the success of the transferor's claim that the initial step of the transaction is a "sale": a necessary corollary of that claim, if upheld, would be that the remitted income is taxable to the transferee, a consequence that the use of a tax-exempt transferee guards against. If our contention that the transfer is not a "sale" is upheld, however, the use of the tax exemption in that respect will never become operative (except, of course, as to the 10% of the income actually kept by the Institute). The only other apparent contribution of the tax exemption is that it may, in the same way, serve to shield the liquidation of the old corporation from a capital gains tax—*i.e.*, if the liquidation would otherwise be "taxable" (*i.e.*, is not a "reorganization") and if the transferor's claim that it is not taxable to him is upheld or, as in this case, is not challenged. Apart

from those two consequences, however, it does not appear that the tax exemption makes any significant contribution to the transaction. That, of course, is not directly germane to the issue before the Court, but it may help to remove some of the obscurity that has surrounded the charity's role in these transactions.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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OCTOBER 1964.

U.S. GOVERNMENT PRINTING OFFICE: 1964

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SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
NOV 2 1964
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1964
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Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE.

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Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF OF AMICUS CURIAE.

Statement of Interest of Amicus Curiae.

This brief is filed *amicus curiae* by the undersigned attorney to comment upon the issues involved, and to advise the Court of the inter-relationship of this case with that of *West Los Angeles Institute for Cancer Research v. Commissioner of Internal Revenue*, pending before but not yet tried by the Tax Court in Docket No. 94372. In that case, the undersigned represents West Los Angeles Institute for Cancer Research, formerly known as California Institute for Cancer Re-

search (herein called the "Institute"); the Tax Court will there consider the tax aspects of the Institute's purchase of the stock of Clay Brown & Company from the respondents in this case and one additional party (herein called the "Brown Group").

Opinion Below; Jurisdiction.

These are adequately set forth in the briefs for petitioner and respondents.

Issue Presented.

Stated narrowly, the issue is whether the Brown Group effected a "sale" to the Institute of the stock and notes of Clay Brown & Company, as the word "sale" is used in Section 117 of the 1939 Revenue Code. Petitioner apparently concedes that there was an arm's length sale in form and in legal and commercial substance (Br. 30, 37-38, 56); but contends that for tax purposes there was a transfer with retention of income rather than a sale.

Stated broadly, the issue is whether there shall be a Rule of Tax Law having reliability and integrity for taxpayers.

The first appearance of a special tax rate upon gain from the "sale" or exchange of a capital asset was 43 years ago in Section 206 of the Revenue Act of 1921 (42 Stat. 232). As used there and in the corresponding provision of succeeding Revenue Acts and Codes, including Sections 117 and 1222 of the 1939 and 1954 Codes, "sale" has had its usual commercial and legal meaning. Petitioner now proposes to give it a special tax meaning that will depend upon the degree of economic risk retained by the seller, as that may vary

from case to case. This would create a large area of tax uncertainty for transactions that have enjoyed tax reliability for the past 43 years.

When in 1953, the Brown Group sold to the Institute their securities in Clay Brown & Company, the commercial meaning of "sale" in the capital gain provision had had an historic acceptance of 32 years. If there was any warning to these parties of Treasury attack upon their transaction, it lay not in the statutory meaning of "sale" but in the area of use by charitable organizations of their exempt income to pay a deferred price. The Brown Group and the Institute might logically have been concerned that the rent to be collected by the latter from Fortuna Sawmills, Inc. (herein called "Fortuna"), could be subjected to a Revenue Service tax claim; except that this risk appeared to have been eliminated by the 1950 amendments to the 1939 Revenue Code (citation *infra*) enacted at the Treasury's instance and laying down guidelines for the taxation of rental income used by a foundation to discharge the price for business properties purchased on credit. The parties considered that they had met Congressional and Treasury requirements when they negotiated this transaction to comply with these recently enacted statutory rules.

For the Revenue Service to contend, beginning in 1954 (Rev. Rul. 54-420, 1954-2 Cum. Bull. 128), that the 1953 sale by the Brown Group was not a sale for capital gain tax purposes, is to strike at the integrity of the Rule of Tax Law.

The Court of Appeals for the Ninth Circuit, in a decision which affirmed the Tax Court, and which is in harmony with a number of other decisions and in

conflict with none (citations *infra*), upheld the Rule of Tax Law. By granting the petition of the Revenue Service for certiorari, this Court has undertaken to re-examine the validity of such a Rule.

Statutes Involved.

In addition to Section 117(a)(4) of the 1939 Code and Section 1222(3) of the 1954 Code, referred to by petitioner (Br. 2), reference is made to the following provisions of the Internal Revenue Code of 1939 (26 U. S. C., 1952 Ed.) as amended by Section 301 of the Revenue Act of 1950 (64 Stat. 906):

"*Sec. 101. Exemptions From Tax on Corporations.* Except as provided in paragraph (12) (B) and in supplement U, the following organizations shall be exempt from taxation under this chapter—

* * * * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation. For loss of exemption under certain circumstances, see sections 3813 and 3814.

* * * * * *

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are

payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Notwithstanding paragraph (12) (B) and supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

Supplement U—Taxation of Business Income of Certain Section 101 Organizations.

Sec. 421. Imposition of Tax.

(a) In General—There shall be levied, collected, and paid for each taxable year beginning after December 31, 1950—

(1) upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b) (1), a normal tax of 25 per centum of the supplement U net income and a surtax of 22 per centum of the amount of the supplement U net income in excess of $25,000; except that (A) in the case of taxable years beginning before April 1, 1951, and ending after March 31, 1951, the normal tax shall be 28¾ per centum of the supplement U net income, and (B) in the case of taxable years beginning after March 31, 1951, and before April 1, 1954, the normal tax shall be 30 per centum of the supplement U net income.

* * * * *

(c) Definition of Supplement U Net Income—The term "supplement U net income" of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000.

* * * * *

Sec. 422. Unrelated Business Net Income.

(a) Definition.—The term "unrelated business net income" means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business, subject to the following exceptions, additions and limitations;

(1) There shall be excluded all dividends, interests, and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or net income from the property, and all deductions directly connected with such income.

(3) There shall be excluded all rents from real property (including personal property leased with the real property), and all deductions directly connected with such rents.

(4) Notwithstanding paragraph (3), in the case of a supplement U lease (as defined in section 423 (a)) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under sec-

tion 423 (d) (1) and there shall be allowed, as a deduction, the amount ascertained under section 423 (d) (2).

* * * * *

Sec. 423. Supplement U Lease.

(a) Definition of Supplement U Lease.—The term "supplement U lease" means a lease for a term of more than five years of real property by an organization (or by a partnership of which it is a member), if at the close of the lessor's taxable year there is a supplemental U lease indebtedness (as defined in subsection (b)) with respect to such property.

* * * * *

(b) Supplement U Lease Indebtedness.—The term "supplement U lease indebtedness" means, with respect to any real property leased for a term of more than five years, the unpaid amount of—

(1) the indebtedness incurred by the lessor in acquiring or improving such property:

* * * * *

(c) Personal Property Leased With Real Property.—For the purposes of this section, the term "real property" and the term "premises" include personal property of the lessor leased by it to a lessee of its estate if the lease of such personal property is made under, or in connection with, the lease of such real estate.

(d) Treatment of Supplement U Lease Rents and Deductions.—In computing under section 422-(a) the unrelated business net income for any taxable year—

(1) Percentage of rents taken into account.—There shall be included with respect to each supplement U lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 per centum) of the total rents derived during the taxable year under such lease as (A) the supplement U lease indebtedness, at the close of the taxable year, with respect to the premises covered by such lease is of (B) the adjusted basis, at the close of the taxable year, of such premises.

* * * * *

The corresponding provisions of the 1954 Code are found in sections 501, 502, and 511-514.

Statement.

Apart from argumentative inferences, Petitioner apparently accepts the fact findings of the Tax Court. [*Cf.* Br. 2-14 with R. 20-57.] These are summarized below. Since a valid purpose of this brief is to acquaint the Court with corollary issues that will be affected by its decision, notably the pending Tax Court case of the Institute, we take the liberty of including in parenthetical italics some facts not of record here but which are expected to be proved in that case.

The Institute was formed as a non-profit charitable corporation in 1945 and took the name "California Institute for Cancer Research" in 1947. Its name was changed to "West Los Angeles Institute for Cancer Research" in 1957. It is described by the Tax Court as "an adjunct of the University of California at Los Angeles." [R. 22-23.]

(Its original members and directors included Dr. Vern O. Knudsen, Dean of the Graduate Division, University of California at Los Angeles, and a number of doctors associated with U. C. L. A. Medical School. Its activities expanded until it became peopled with several hundred volunteer directors, committee members and members of auxiliary organizations, including a number of prominent citizens. It has collected several hundred thousand dollars in donations from the public and other foundations and largely contributed these funds for cancer research. Nearly $200,000 of contributions had been received before the Institute's first purchase-lease transaction in 1951. In addition to collecting funds for and channeling them to worthy cancer research projects, the people of the Institute have devoted much time to furthering cancer research in various ways. For example, they played an important role in securing housing for the cancer wing in temporary buildings during the construction of the Medical Center at U. C. L. A. and have worked with the United States Public Health Service and other organizations to advance this worthy cause.)

(Prior to the summer of 1951 the Institute had become acquainted with transactions which the Loyola Foundation had been making for some years with the advice of a competent tax attorney. Such a transaction involved the credit purchase of a going business by the foundation and the lease of its assets to a new operator, enabling the foundation to pay the price out of a tax-free rental. The Institute was advised that such transactions had been accepted at face value by the Internal Revenue Service and had been expressly sanctioned by 1950 amendments to the Internal Revenue

Code, provided the lease period was limited to five years. In reliance upon the foregoing and upon the advice of the same tax attorney, the Institute entered into two such transactions; one in 1951 for the purchase of a business known as Ward Mayer Structures, Inc.; and the second in 1953 for the purchase of Clay Brown & Company. The Loyola Foundation transactions and the Ward Mayer purchase involved essentially the same pattern as that presented in the purchase of Clay Brown & Company.)

Prior to 1953, all of the stock and $125,000 of notes of Clay Brown & Company were owned by the Brown Group, none of whom had any connection with the Institute. [R. 21, 23, 30.] That Company's lumber milling business was quite successful, having earned about $339,000 a year before taxes over its 2½ year history. [R. 35.] After considerable negotiation the Institute agreed to pay $1,300,000 for the stock and notes, this being less than the asking price and more than the first offer. After deducting an estimated interest factor, this price, amounted to about $1,065,000 for the stock and notes, or $940,000 for the stock alone; it was reasonable and was supported by the earnings record as well as an appraisal of tangible assets by General Appraisal Company. [R. 23-37, 64.] The Institute's officers expected it to be paid in five years. [R. 36.]

(Should rents fall short of the amounts required to pay the purchase price, the directors and officers of the Institute anticipated that they would be able to arrange independent financing in order to complete payment.)

In February 1953, the stock and note purchase and subsequent proceedings were carried out in accordance with a series of legal documents that had been care-

fully drawn and approved by the Brown Group and their attorneys, as well as the Institute's legal committee and directors.[1] [R. 37-44.] The events, in order of occurrence, were as follows:

Sale and transfer of the stock and notes of Clay Brown & Company to the Institute for a price of $1,300,000, payable $5,000 down with a note for the balance due not later than January 1, 1963, bearing interest only after maturity, payable from 90% of rentals received, but not less than $250,000 in each two consecutive years;

Liquidation of Clay Brown & Company and transfer of its assets to the Institute;

Mortgaging of the assets to secure the unpaid price;

Execution of a five-year lease of the real estate, plant and equipment by the Institute to Fortuna, a newly formed company the entire stock of which was owned by Calvin N. Souther and William H. Kinsey, who invested and risked therein $25,000 of their own funds not obtained directly or indirectly from the Brown Group;

Lease provision for a rental of 80% of Fortuna's annual net profits, computed before depreciation and income taxes, but in any event at least $277,778 in each two-year period, the lessee to maintain the premises in good repair and pay taxes and insurance;

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[1]See R. 244-6 for a list of the directors and legal committee of the Institute. Directors included a number of prominent business and professional people, such as the Dean (Dr. Warren) and former Dean (Dr. Knudsen) of U.C.L.A. Medical School. The legal committee was composed of two judges and a practicing attorney.

Sale of the current assets by the Institute to Fortuna at their net book value payable by assumption of the liabilities of the business plus Fortuna's note to the Institute for about $21,000.

During the 1953-57 period Fortuna operated the lumber milling business and paid to the Institute $703,992 of rent, and $12,630 of other amounts including proceeds of a sale of assets. The Institute paid $651,095 to the Brown Group upon the price. [R. 56.] In addition, Fortuna spent significant sums upon the Institute's capital assets and took rental credit therefor, pursuant to a lease provision authorizing $25,000 a year of such expenditure and credit.[2]

In conducting its operations, Fortuna employed the working staff formerly employed by Clay Brown & Company, under the supervision of Souther, Kinsey and a member of their law firm who acted as officers and directors. Clay Brown was general manager for about 21 months and thereafter was retained as an adviser at a reduced salary. Fortuna made 27 bank loans, ranging up to $55,214, of which one was guaranteed by Clay Brown.[3] [R. 41-42, 48-49, 56.]

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[2]Lease and License Agreement, Ex. 49-WW, Sec. 8, R. 218. The amounts so expended presumably are available in the original record, though not revealed by the printed record.

[3]Clay Brown had sufficient interest in his compensation from and his lien upon rental obligations of Fortuna to make such action economically viable; it did not mean that he, or others of the Brown Group who made no such guarantee, were in any sense owners of Fortuna or participants in its profits or losses.

(The unrelenting attacks of the Revenue Service upon the Institute, and upon the parties who made sales to and leases from it, have been ruinous to the Institute's hopes of deriving substantial profit for cancer research from the two purchase-lease transactions.)

(Shortly following the issuance of Rev. Rul. 54-420, the Institute voluntarily went to the Revenue Service for clarification of applicability to the Institute and its transactions. At about the same time there began a long series of negotiations and disputes between the Institute and the other parties, directly consequent upon Revenue Service disapproval of the latters' position as sellers and rent-payers.[4])

(After prolonged discussions with the Revenue Service, the Institute faced withdrawal of its tax exemption, which would have terminated its ability to receive tax deductible donations and killed the activities of its large volunteer organization in collecting them. The law provides no way of testing the validity of such administrative action before its devastating impact. Therefore, the Institute was compelled to reorganize. At the end of 1956, a new non-profit corporation was formed with the name "California Institute for Cancer Research"; the large voluntary organization of the Institute—directors, officers, and committees—shifted to the

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[4]Although the rent deduction of Fortuna has apparently never been questioned, the rent deduction of Timber Structures, Inc. has; the latter corporation is the lessee of the properties acquired by the Institute in the *Mayer* transaction.

new corporation; the Institute changed its name to "West Los Angeles Institute for Cancer Research" and was thereafter managed by a small group of volunteer directors and officers with the objective of defending its assets and, at the end of the trouble, contributing their remainder to the California Institute for Cancer Research.)

(This defense, all directly consequent upon the Revenue Service attack, has wiped out the Institute's substantial cash resources and left it with only a doubtful hope of salvaging some contribution for the charitable purpose.[5])

Summary of Argument.

To save time and space, the Court is respectfully referred to the argument headings in the table of contents for the Summary of Argument for this brief.

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[5]The sellers in the *Mayer* transaction brought suit for rescission based upon tax frustration, although they had not defended their tax position beyond the administrative stage. This exhausting substantive litigation is still not finally resolved. Were the Revenue Service a private party, which thus interfered in the contractual relations of others, it might well be the object of a damage suit.

ARGUMENT.

1. Although This Was a Sale to a Charitable Buyer It Was Within Sound Public Policy.

In 1951, the Institute, a worthy public charity, was seeking to enhance its resources for cancer research. It purchased a business corporation in 1951, and a second one, Clay Brown & Company, in 1953, expecting to pay the price for each out of five years' tax exempt rental from the business properties. It was recognized that some refinancing might be required, but nevertheless believed that shortly after five years, income from the properties or proceeds from their sale would be available for cancer research.

In each instance the sellers were businessmen of the entrepreneur class who had built successful businesses and wanted to receive the fruits of their labors. They were presented with an economic choice commonly faced by businessmen with such a purpose: either to sell for a fixed price and pay capital gain tax upon the profit; or to retain the business and pay ordinary income tax on profit withdrawn. This choice, which is part of the fundamental pattern of our economic life, is the same whether the buyer is or is not a tax exempt organization. It is part of the encouragement to entrepreneurs afforded by our tax laws that they should have this choice, and has been since 1921.[6]

When the Institute became the buyer of Brown & Company, two worthy ends of public policy were

[6]The sellers to Loyola Foundation whose tax cases are cited under Point 4, *infra.*, will be seen also to be businessmen of the entrepreneur class. In this day of big government, big business, and big labor unions, there is a terrible economic squeeze upon the entrepreneur who, singly or with partners, attempts to build a business of his own. He needs all the encouragement he can get.

served: the Brown Group were afforded their choice to sell and take the deserved gain at the deserved capital gain tax rates; the Institute was securing financial resources to further cancer research.

Had the price paid by the Institute been out of line with that customarily commanded by a like business, there might be grounds for suspecting an accommodation designed primarily to thwart tax laws rather than serve legitimate economic and charitable ends. Such, however, was not the case.

The average annual earnings of Brown & Company before taxes were $307,000, unadjusted, or $339,000 after adding back certain capital expenditures. They had been $415,000 in the year ended April 30, 1951, and although there was an intervening drop, appeared to be back to that level for the year ended April 30, 1953. [R. 35.] The price agreed to in the course of extended negotiations was $1,300,000, payable over an expected five years without interest. The interest factor was about $237,000, leaving about $1,065,000 as the principal element, which was not greatly in excess of the appraised value of the tangible assets. [R. 31-32.] In the vital respect of its ratio to earnings, this price was less than eight times after-tax or four times before-tax average earnings; and in terms of the rate of annual earnings at the time of sale, it was less than six to one after taxes or three to one before taxes. It would be a bargain today; particularly so in view of the market-place rule-of-thumb that price

tends to increase in direct ratio to the deferred portion of the payment.

The Tax Court was conservative when it found this price to be "within a reasonable range." [R. 64.]

The significant economic fact about the transaction was: The Brown Group parted with their business for a fair price which, although deferred, was confidently expected to be paid from earnings, from the Institute's independent resources, or both. This was a sale. It is and was within sound public policy to so regard it for tax purposes.

2. The Only Viable Question Is Whether a Charitable Organization Should Enjoy Tax Exemption for Rental Income Used to Purchase Business Properties. This Is a Question of Fiscal Policy to Be Answered by Congress.

Although public policy favors financial encouragement to worthy charities, a question of fiscal policy arises when such charities acquire business properties and enjoy tax exemption for the resulting income. This tends to lessen the revenue and may disturb general business economics. It may permit charities to compete unfairly with privately owned business.

Specifically, it facilitates acquisition of business properties by exempt organizations because, like any other buyer, the charity will bargain in terms of price as a multiple of proven and expected income; but the charity will think in terms of exempt income. This is so regardless of whether the terms are all cash, part

cash, or no down payment; which underscores that the true fiscal problem is not the presence or absence of a down payment.

Whether and to what extent the business income of charities should be taxed is typically a problem for Congress.[7] Congress has, in fact, carefully dealt with that problem.

3. At the Treasury's Instance Congress Amended the Internal Revenue Code in 1950 to Control the Credit Purchase of Businesses by Tax-Exempt Organizations.

For many years prior to 1950 the Treasury had been contesting the right of a charitable foundation to secure tax-free income from a business enterprise, particularly if that income was used by the foundation to purchase the enterprise. After unsuccessful litigation, and an unsuccessful attempt at legislation in 1942, the Treasury was successful in securing remedial legislation in the Revenue Act of 1950. See the discussion of this history in *C. F. Mueller Co. Commissioner,* 14 T. C. 922, 932 (1950), and in the opinion of the Third Circuit Court of Appeals, reversing the Tax Court. 190 F. 2d 120 (1951). See also, *Roche's Beach, Inc. v. Commissioner,* 96 F. 2d 776 (2d Cir. 1938).

The problem was thoroughly analyzed by Congress in 1950. *House Report No. 2319,* Ways & Means Committee, 81st Congress, Second Session, 1950-2 Cum. Bull. 380, 480-411.[8] The Committee refers (p. 409)

[7]As noted by the Court below, R. 295-6. It is the problem to which the commentators direct, or should direct, their attention. See articles cited by the Court below [R. 291] and petitioner (Br. 23, Ftn. 9.)

[8]See also the Senate Committee Report which is generally in accord. Report 2375, 81st Congress, Second Session, 1950-2 Cum. Bull. 483 at 502 *et seq.*

to instances where exempt organizations "have, in effect, used their tax exemption to buy an ordinary business * * * with no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable." There is discussion (p. 410) of the purchase-lease situation where the foundation "does not use its own funds" but "borrows the price and pays off this loan" from "rental income received for a period of years" thus obtaining "unencumbered title" although "investing little or nothing in the venture." This is objectionable because the only "contribution" by the foundation "is its tax exemption" and the only reason why it "received the property at no expenses to itself is the fact that it pays no income tax on the rentals received"; that since "borrowed funds may represent 100% of the purchase price" there is no limit to the expansion of ownership by exempt organizations of income producing properties, with consequent shrinkage of revenue; that this may in effect constitute a sale of a foundation's exemption through the means of "paying a higher price" than would be involved if normal taxes applied, but in an area where proof "is difficult to obtain because the purchase price * * * which a taxable business would agree to pay is unknown". The exempt organization "because of its tax free status, can afford to pay the higher price and still make a profit on the transaction. This is especially likely to occur where the exempt organization is presented an arrangement which does not require the commitment of any of its own funds."

The remedy adopted by Congress was not to classify a credit sale to an exempt organization as a non-capital-gain sale, and not to withdraw the organization's ex-

emption, but to tax to the organization rentals from business properties purchased on credit and leased for more than five years.

Specifically Section 101 of the 1939 Code was amended (by Sec. 301 of the Revenue Act of 1950, 64 Stat. 906) by adding at the end paragraphs designed to deny the exemption to an active business feeder corporation, *i.e.*, one operated for the primary purpose of carrying on a trade or business for profit; but this provision states that for its purposes "trade or business shall not include the rental by an organization of its real property (including personal property lessed with the real property)."

The other part of the 1950 amendment was to add Supplement U taxing unrelated business income and providing a complex and precise statutory pattern of taxation of business lease income. Specifically, 1939 Code Section 422(a)(3) excludes from "unrelated business net income" (taxable under Sec. 421) "all rents from real property (including personal property leased with the real property)"; Section 422(a)(4) provides, notwithstanding, that rental from a "supplement U lease" shall be taxed as provided in Section 423; and Section 423 provides that a "supplement U lease" is one for more than five years (*i.e.*, rent from a five year or shorter lease is tax free), that "supplement U lease indebtedness" is indebtedness incurred in acquiring or improving the property, and that rent is taxable in the ratio of year-end supplement U lease indebtedness to adjusted basis of the property.[9] The cor-

[9]If rent had been received by the Institute from Fortuna, after expiration of the five year lease, it would have been taxed under the last mentioned formula. See 1954 Code Sec. 514(b)(2)(B).

responding provisions of the 1934 Code are found in Sections 511-514.

4. The Commissioner Has Not Accepted the Remedy Provided by Congress. Since 1954 He Has Broadly Attacked Exempt Organization Credit Purchase Transactions.

For several years after the enactment of the 1950 amendments the Commissioner did not find fault with transactions like the one before this court, which had been entered into by the Loyola Foundation and the Institute.[10] However, in the fall of 1954 the Revenue Service opened a broad scale attack upon such transactions by issuing Revenue Ruling 54-420 (1954-2 Cum. Bull. 128) which is reproduced in Appendix A to this brief.

Since 1954 the Service has litigated a number of cases involving credit purchase of business properties by exempt organizations, in which it has challenged the exemption of the purchaser and the seller's right to long term capital gain. In this litigation the Commissioner has lost the following imposing list of cases: the decision below; *Union Bank, Executor v. United States,* 285 F. 2d 126 (Ct. Cl. 1961); **Anderson Dairy, Inc. v. Commissioner,* 39 T. C. 1027 (1963);

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[10]Loyola Foundation has made a number of purchase lease transactions involving rentals computed as 80% of the profits of the lessee and requiring payment of 90% of the rentals on the price; some of these antedating the 1950 amendments. It is the writer's understanding that prior to 1954 the Internal Revenue Service audited exempt returns of Loyola Foundation reflecting such transactions and did not disturb them. The writer personally was not involved in the 1951 and 1953 purchases which the Institute made; but early in 1954, on behalf of the Institute, he inquired of the Internal Revenue Service in Washington concerning its attitude toward such transactions and was advised that they were not being challenged.

Estate of Ernest G. Howes v. Commissioner, 30 T. C. 909 (1958), aff'd *sub. nom. Commissioner v. Johnson*, 267 F. 2d 382 (1st Cir. 1959); *W. H. Truschel v. Commissioner*, 29 T. C. 433 (1957), acq. 1960-1 Cum. Bull. 6; *Estate of James L. Hawley v. Commissioner*, 20 T. C. M. 210 (T. C. Memo. Dec. 2/17/61); *Estate of Cordie Hawthorne*, 19 T. C. M. 770 (T. C. Memo. Dec. 6/30/60.); *A Shiffman v. Commissioner*, 32 T. C. 1073 (1959), acq. 1960-1 Cum. Bull. 5; *Ohio Furnace Co. v. Commissioner*, 25 T. C. 179 (1955); *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956); **Royal Farms Dairy Co. v. Commissioner*, 40 T. C. 172 (1963); **Ralph M. Singer v. Commissioner*, 22 T. C. M. 759 (T. C. Memo. Dec. 6/7/63); **Isis Windows, Inc. v. Commissioner*, 22 T. C. M. 837 (T. C. Memo. Dec. 6/27/63) **Oscar C. Stahl v. Commissioner*, 22 T. C. M. 996 (T. C. Memo. Dec. 6/29/63).[11]

The starred cases, which are on appeal to the Ninth Circuit Court of Appeals, and the *Union Bank* case, involve sales to Loyola Foundation (or University Hill Foundation, as it is now called) upon terms similar to those of the Institute's purchases. In *Estate of Hawley* and *Estate of Hawthorne*, the payment arrangements were also dependent on profits or income. In all of the

[11]A number of the cited decisions, including those here under review, have rightly distinguished *Emanuel N. Kolkey v Commissioner*, 254 F. 2d 51 (7th Cir. 1958, *aff'g* 27 T. C. 37) which involved an essentially sham sale to a feeder corporation created to act as buyer, for an unrealistic price represented by a large note issue, where connection of the exempt organization with the feeder was ownership of a miniscule stock issue that was reacquired by the sellers before the end of the feeder's first fiscal period. This decision illustrates that the Revenue Service has a remedy in this, as in other areas, to prevent tax avoidance through the use of devices without economic significance.

cited cases, regardless of the precise formula for payment, the plan was for the exempt organization to pay the price from the earnings of the business enterprise.

The Commissioner's brief to this Court is singularly silent about the 1950 amendments. Rev. Rul. 54-420 is devoid of reference to them. The Revenue Service wherever possible has avoided mentioning them in the litigated cases, including the proceedings below.

The focal points of the historical picture, then, are: Congress has clearly spoken in 1950 upon the subject of the acquisition of business properties by charitable foundations and payment of the price out of tax-exempt rental; it has recognized that the foundation usually does not commit its own resources or make a down payment; it has carefully spelled out a remedy that does not deny capital gain benefit to the sellers or tax exemption to the buyer but, instead, controls the kind and amount of tax-exempt rental that may be used to pay the price. Nevertheless, the Revenue Service has made a broad scale attack upon the tax advantages that Congress has sanctioned; that attack has been unsuccessful in case after case. This appeal is another phase of that attack.

5. Petitioner Contends That for Tax Purposes Respondents Made a Transfer With Income Retained, Rather Than a Sale. This Is a New Issue Which May Not Be Presented for the First Time in This Court.

This controversy originated with the issuance of Rev. Rul. 54-420 (Appendix A to this brief). Neither the Revenue Ruling nor the deficiency notices in this case gave any legal reason for denying the capital gain bene-

fit. The deficiency notices tax as ordinary income not the full receipts, but only the gain as it would be computed upon a sale. [R. 8-15.]

In the Tax Court the Revenue Service contended that the sale gain here should be denied the capital gain benefits of Section 117(a) of the 1939 Code because of the substantial incidents of ownership retained by the sellers. [R. 58-59.] It also argued that the transaction was a sham, but abandoned that point in the Court of Appeals. [R. 294.]

Here petitioner contends that respondents made a transfer of stock with retained income interest which was not a sale for any tax purpose, and petitioner observes (Br. 71-75) that a remand will be required to try further questions. Petitioner says that as a result of his new theory, it must be assumed that there was either a tax-free organization by respondents of Brown & Company into Fortuna, or a taxable liquidation of Brown & Company attributable to respondents. In either event, he says, respondents may be taxable as having received constructive dividends, in the one alternative from the reorganized corporation, in the other from a thinly-capitalized Fortuna in which respondents have made a constructive capital investment. The taxable amount of the constructive dividends would depend upon "by whose earnings and profits their treatment is governed." (Br. 75.) In the second alternative, the receipts may have constituted rents, not dividends, in which event the net income taxable to respondents would depend upon "what basis respondents may use for depreciation." (Br. 75.)

Thus, petitioner brings his case here upon an issue not presented at the original trial, which would require a new trial of new questions in order to determine re-

spondents' tax liability. This would deny to respondents the justice of repose from repeated litigation of the same dispute. *Burnet v. Commonwealth Improvement Co.*, 287 U. S. 415 (1932); *General Utilities & Operating Co. v. Helvering*, 296 U. S. 200 (1935); *Helvering v. Salvage*, 297 U. S. 106 (1936); *Helvering v. Wood*, 309 U. S. 344 (1940). In *Hormel v. Helvering*, 312 U. S. 552 (1941), this Court (pp. 556-557) said: "Ordinarily an appellate court does not give consideration to issues not raised below"; but permitted presentation of a new issue by the appellant "to promote the ends of justice" because a controlling Supreme Court decision had intervened between trial and appeal.

In this case there is no such justification for presentation of a new appellate issue by petitioner. To permit it would defeat, not serve, the ends of justice.

6. Petitioner Has Presented No Adequate Reason for Unsettling the Meaning of "Sale" in the Tax Statutes or Changing the Rule of Tax Law Upon Which Respondents Relied.

Even if this Court decides to listen, petitioner's new theory must be rejected as untenable. It is contrary to a substantial and uniform body of decisions upholding capital gain treatment for credit sales to tax-exempt organizations (citations under Point 4, *supra*). It is unsupported by any valid analogy from other areas of tax law and is refuted by many such analogies. It would deprive the word "sale" in the capital gain statute of the accepted legal-commercial meaning that it has enjoyed since 1921; it would retroactively tax a bona fide sale made in reliance upon that accepted meaning; it would create chaotic uncertainty as to the applicability of this statute. It would permit administrative legislation.

In short, petitioner's theory would deny reliability of a Rule of Tax Law to taxpayers generally, and would deny its integrity to respondents in this case and others similarly situated.

A. "Sale" in the Tax Statutes Should Not Have an Esoteric Meaning but Should Apply to an Arm's Length Sale at Substantive Law.

The sale here had economic significance, was negotiated at arm's length between strangers, and passed ownership from sellers to buyer for a stated price. It was a sale of stock by the substantive law of the sellers' residence (*Ore. Compiled Laws Ann.* Sec. 78-101) and the buyer's (*Cal. Corp. Code* Sec. 2466). Under such laws, the occurrence of a sale did not depend upon a down payment or the personal liability of the buyer for the price. In fact, California law prohibits enforcement of a purchase money obligation against the buyer of real and personal property (*Code of Civ. Proc.* Sec. 580(b)) and the Oregon law does so for real property (*Ore. Rev. Stats.* Sec. 88.070).

In California, sales occur by the thousands with little or no down payment and no personal liability of the buyer. So far as the writer is aware, the Revenue Service has always treated them as sales for tax purposes, except in its present campaign against sales to exempt organizations.

Petitioner does not deny that this was a substantive sale between strangers, but does deny that it was a sale for tax purposes particularly the purposes of Section 117 of the 1939 Code and Section 1222 of the 1954 Code.

"Sale" is a term of commonly accepted meaning. The current Internal Revenue Code is a complex and detailed statute containing many precise definitions.[12] Unless the statute specifically defines such a common word in some esoteric sense, the Courts certainly should not do so.[13]

B. Petitioner Proposes That the Pattern of Tax Statutes Relating to Sales Should Not Apply to This Substantive Sale.

The capital gain provisions may not sensibly be isolated from the pattern of interwoven tax statutes dealing with sales, exchanges and dispositions. A brief review of the statutory pattern is in order.

Basically, gain or loss from the "sale or other disposition of property" is measured by comparing the "amount realized" with basis; and is recognized upon "the sale or exchange of property" except as specifically otherwise provided. *Secs. 111, 112(a); Secs. 1001, 1002.[14] Exceptions to this rule are carefully spelled out. *Secs. 112(b) *et seq.*; Secs. 1031 *et seq.* 332, 351 *et seq.* Where payment of price is deferred, the seller

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[12]The Revenue Act of 1921 covered 109 printed pages. The current version of the 1954 Internal Revenue Code covers about 1,500 printed pages. All of the intervening years, except 1922 and 1925, have seen new Revenue Acts or amendments to the Revenue Codes and in recent years these have been numerous and voluminous.

[13]*The Hanover Bank v. Commissioner,* 369 U. S. 672 (1962); *Crane v. Commissioner,* 331 U. S. 1 (1947). In *Helvering v. Flaccus Oak Leather Co.,* 313 U. S. 247 (1941), this Court applied the stated principle to the words "sales or exchanges" in the capital gain and loss statute.

[14]Section references in this subdivision are to the Internal Revenue Codes of 1939 and 1954, the starred references being to the 1939 Code. Starred regulation references are to Regs. 118 under the 1939 Code.

may elect to report gain (but not loss) by the installment method. *Sec. 44; Sec. 453. The regulations lay down careful rules surrounding the installment election and the consequences of repossession. *Reg. 39.44; Reg. 1.453. The buyer of property is given a basis of "cost", that is, price paid. *Sec. 113(a); Sec. 1012. Gain from the "sale or exchange" of capital assets is taxed at a reduced rate and the deduction of loss therefrom is carefully restricted. *Sec. 117; Secs. 1201-1212, 1221-1223, 1231 *et seq.*

Petitioner's contention that the transaction here was a transfer with retained income, and his reliance upon the analogy of the oil and gas cases, apparently would remove this transaction from the entire statutory pattern pertaining to sales. Petitioner could not well contend, for example, that respondents were subject to tax upon gain from a sale that is recognized as such under *Section 112, while also proposing that the periodic payments to them should be taxed as retained income.

Petitioner faces unsurmountable difficulties with his proposed interpretation.

C. The Oil Interest Cases Upon Which Petitioner Relies Are Not Analogous to a Credit Sale of Non-Depletable Property. The Tax Consequences of the Latter Cannot Sensibly Depend Upon the Buyer's Down Payment or Personal Liability.

In his contention that the Brown Group for tax purposes made an income retained transaction, not a credit sale of the stock of Brown & Company, petitioner relies primarily upon an anlogy to decisions involving depletable interests in oil properties.

The fundamental problem in the oil cases is that the capital investment in the oil is converted into money only through a piecemeal sale of the capital asset itself. The depletion allowance[15] was granted by Congress "on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit" and "is designed to permit a recoupment of the owner's capital investment" therein; however, the allowance "bears little relationship to the capital investment" and "continues so long as minerals are extracted, and even though no money was actually invested in the deposit."[16] In light of "complexities of oil operations and risks incident to prospecting" leading to "intricate, multiparty transactions" the problem has been "to determine which parties are entitled to a part of the allowance" where the "statute merely provides" that it "should be 'equitably apportioned between the lessor and lessee' ".[17]

"Congress", this Court has observed, "has recognized the peculiar character of the business of extracting natural resources" and accordingly made provision "for equitable apportionment of the depletion allowance".[18] "As the oil is extracted and sold" the interest of each participant "is reduced" thereby entitling him to "his equitable proportion of the depletion".[19] This Court has also said that Congress "cannot be taken to have

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[15]1954 Revenue Code, Secs. 611, 613; 1939 Code, Secs. 23(m), 114(b)(3).

[16]*Commissioner v. Southwest Exploration Company*, 350 U. S. 308, 312 (1956).

[17]*Id.* p. 313.

[18]*Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25, 33-34 (1946).

[19]*Id.* p. 35.

intended that an oil and gas lease under the capital gains provision, any more than a mineral lease under the earlier acts, should be treated like an ordinary sale of land or chattels."[20]

In facing the transfer of an oil property along with tangible equipment, for a royalty interest and cash, this Court has distinguished the retention of the depletable oil interest, a nontaxable event, from the sale of the depreciable equipment, which was a taxable event resulting in a deductible loss.[21]

Petitioner brushes lightly over *Helvering v. O'Donnell*, 303 U. S. 370 (1938) (Ftn. 26, Br. 47-48) as "all but overruled",—hardly a warrantable conclusion in view of its continued citation by this Court. That case is embarrassing to petitioner because it held that a sale of stock of an oil corporation in return for payments to be measured by profits from the corporation's oil properties was a sale, not a retention of depletable interest. It made a correct distinction. Before the stock sale the corporation, not the shareholder, was entitled to depletion on the oil interest; money could come to the shareholder only through taxable dividends or a taxable sale or disposition of his shares. When the shares were sold, the corporation continued to own the depletable oil interest, unless the buyer of the shares dissolved the corporation and acquired that interest, which event would not *ipso facto* pass the depletable interest back to the seller of the shares.

Each owner of an oil interest continues to draw his income and deduct his depletion until his interest is paid

[20] *Burnet v. Harmel*, 287 U. S. 103, 108 (1932).

[21] *W. G. Choate v. Commissioner*, 324 U. S. 1 (1945); *cf. Thomas v. Peckham Oil Co.*, 115 F. 2d 685 (CCA 5th, 1940).

out or exhausted, at which point nothing transfers to a new owner; there is never a sale.

By contrast, where ordinary business properties are sold for a deferred price they are transferred to a new owner, not exhausted. The sale is effective under both substantive and tax law, when title "passes" or when "possession and the burdens and benefits of ownership are * * * transferred * * * whichever occurs first".[22] As a matter of timing, the effective date is not postponed until payment of the deferred price has been completed; but even if it were, there would at the latter date necessarily be a transfer of ownership—*i.e.*, sale—of properties which, in this era of expansion and inflation, probably have become more valuable with the passage of time.

Consequently, there is no sensible analogy from the oil interest concept to the credit sale of nondepletable property, and the attempt to draw one merely creates strange problems.

For example, consider a California shopping center, built with borrowed funds on a 99-year leasehold, and sold several times at increasing prices as its success is demonstrated. It may well be that neither the original owner nor any subsequent buyer has paid any substantial cash for his acquisition. The insurance company that holds the first mortgage has waived any personal liability,[23] and the junior purchase money mortgages involve none. All of the credit is at risk upon the shop-

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[22]0.988, Cum. Bull. No. 2, p. 84 (1920). This venerable revenue ruling is still generally followed.

[23]This is standard procedure. Alternatively, the borrower may use a corporate front to insulate himself.

ping center and its future.[24] Commercially, and in the eyes of the Revenue Service, each of the transfers of equity has effected a sale, with all of the complex tax results that follow under the statutory pattern. Taxpayers and Service alike would be dismayed now to learn that there were no taxable sales; no changes in depreciation base; instead, the mortgage holders, along with the last equity owner, all have ownership and income interests of some peculiar sort.

Petitioner's argument is so absorbed in its analogy to depletable assets that it fails to analyze the tax consequences of a successful credit sale of nondepletable property. In fact, most of such sales do pay out even though the buyer has not made a down payment or incurred personal liability. This was or will be the result in most of the sales to foundations involved in the cases cited under Point 4, *supra*. It was the expected result in the instant case.

Let us think in terms of two no-down-payment sales, in each of which the buyer has completed payment of the price; the seller no longer has any claim upon the property. One of such sales was made in California, which permits no deficiency judgment on foreclosure; the other was made in State X, which permits a deficiency judgment. Petitioner would not deny that the sale in State X had tax validity. (Br. 49.) The seller would have paid tax at the capital gain rate, probably upon the installment basis; at the date of the sale, the buyer would have secured a basis equal to the price.

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[24]In the normal transaction, this is wholly or largely the case; the equity money, if present, is of minor credit significance.

Even though in both California and State X the property has been sold and paid for in transactions that are commercially and legally identical, petitioner would have us give strange treatment to the California seller and buyer. The seller, not the buyer, would be taxable on income from the property during the pay-out period, and the buyer would have a zero basis.[25] A host of collateral questions are raised: Is the seller's basis amortizable against payments or deductible at some point as capital loss,[26] and would this change if his basis were equal to or greater than selling price? Would the transaction be converted to a taxable sale if the buyer paid out before maturity by refinancing or using his own funds? Would the seller be taxable upon payments made in a period when the buyer had no taxable income, and would the buyer have a carry-over or carry-back deduction against income of a different period? What of payments having their economic source in property additions paid for by the buyer or in the buyer's services—would these be price or income to the seller? If the buyer resold subject to the unpaid first mortgage and took payment by second mortgage, would this, too, be a transfer with retention of income? Would the new buyer be denied any basis, even in the amount of the first mortgage?[27]

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[25]This Court has noted that its distinction between the nature of payments as price, on the one hand, or return of income, on the other, "affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. at p. 27.

[26]Petitioner's emphasis upon the dividends-income concept of the seller's position suggests that the seller's basis would not be amortizable against payments as received.

[27]Contravening *Crane v. Commissioner*, 331 U. S. 1 (1947).

There is no basis in the economics or in substantive law to distinguish between the State X sale and the California sale. It is not clear that the revenue would be augmented by petitioner's peculiar treatment of the latter.

It is certain that the complex pattern of the tax statutes cannot possibly accommodate petitioner's suggested treatment. If this Court were to adopt it, the Revenue Service, taxpayers, and other courts would be left in a never-never land of writing tax law from case to case.[28]

D. The Substantive Sale by Respondents Was Made in Reliance Upon an Historic Acceptance of the Commercial Meaning for "Sale" in the Tax Statutes, Particularly the Installment Sale Provisions.

It is obvious that the Brown Group would not have made a deferred price sale of the Brown & Company stock to the Institute, or to any other buyer, had they anticipated in 1953 that it might later be interpreted to be an income-retention transaction. At the time of their sale, there was a well-settled acceptance of the commercial meaning of "sale" for tax purposes,[29] and no inkling of the special exception that petitioner now urges. Even after the 1954 issuance of Rev. Rul. 54-420 there was no warning that the capital gain treatment was in jeopardy for credit sales, unless made to a tax-exempt organization.

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[28]Although petitioner does not forewarn the Court of the terrifying tax complications faced by his retained income transactions, he does admit that a case-by-case analysis will be necessary to distinguish them from sales. (Br. 58.)

[29]Except for specific statutory exceptions or additions, *e.g.*, 1939 Revenue Code Secs. 117(f)-117(p).

Acceptance for the tax statutes of the commercial meaning of "sale" is so old and widespread that one may see its evidence almost everywhere and its contradiction almost nowhere.[30] This acceptance has not been altered because the price, or part of it, was dependent upon future income from the property sold, and therefore at risk.[31] The Revenue Service has been at pains to reinterpret a deferred payment (lease) transaction as a sale for tax purposes because that assertedly was its commercial substance.[32]

The area of tax law having particular interest for the Brown Group in 1953 pertained to installment sales, and it was squared off with sharp corners.

As interpreted by Regs. 118, Sec. 39.44-2(c), the installment method of reporting was unavailable unless there was at least one payment in the year of sale, and at least one payment subsequent thereto. The technical-mechanical nature of this requirement was explained in G. C. M. 12148, XII-2 Cum. Bull. 57 (1933). The Brown Group had to be careful to secure a small down payment.

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[30]See, for example: *Helvering v. Hammel*, 311 U. S. 504 (1941); *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934); *Ohio Brass Co. v. Commissioner*, 17 B. T. A. 1199 (1929), *acq.* IX-2 Cum. Bull. 45; *Rialto Mining Corp. v. Commissioner*, 25 B. T. A. 980 (1932), *acq.* XI-1 Cum. Bull. 6; G. C. M. 12012, XII-2 Cum. Bull. 60 (1933); G. C. M. 21503, 1939-2 Cum. Bull. 205. *Cf. Le Tulle v. Scofield*, 308 U. S. 415 (1940).

[31]*Helvering v. O'Donnell*, 303 U. S. 370 (1938); *Burnet v. Logan*, 283 U. S. 404 (1931); *Vermont Transit Co., Inc. v. Commissioner*, 218 F. 2d 468, 469-70 (2d Cir. 1955), *cert. denied* 349 U. S. 945; Rev. Rul. 58-353, 1958-2 Cum. Bull. 408; Rev. Rul. 60-226, 1960-1 Cum. Bull. 26. *Cf.* 1954 Revenue Code, Sec. 1235.

[32]Rev. Rul. 55-541, 1955-2 Cum. Bull. 19; Rev. Rul. 55-540, *id.* p. 39; Rev. Rul. 57-371, 1957-2 Cum. Bull. 214. *Cf.* 1954 Revenue Code, Sec. 162(a)(3); 1939 Code, Sec 23(a)(1)(A).

Failure to comply with the strict installment election requirements meant accrual of the entire gain in the year of sale regardless of the amount of deferred price.[33] Even where collectibility was seriously doubtful, the issue judicially considered was not whether a sale had occurred but whether the taxpayer could defer reporting gain until after recovery of basis; the focal point of the enquiry was whether the property sold had sufficient value to secure the purchase money debt.[34]

The 1954 Code specifically permits reporting a sale by the installment method, even if there are no payments in the year of sale. Section 453(b)(2). The Committee Report states that this change was to avoid leaving "in doubt, for perhaps a number of years, the status of certain sales in which the initial payments are indefinite and are not payable until some time subsequent to the year of sale."[35]

The rules laid down for the Brown Group specified not only that they had made a taxable installment sale, but also that they would face a second taxable event upon repossession; Regulations 39.44-3(b) would have

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[33]*Pacific National Co. v. Welch*, 304 U. S. 191 (1938); *Peter Mamula v. Com.*, 41 T. C. 572 (1964) (on appeal to Ninth Circuit); *John W. Commons v. Com.*, 20 T. C. 900 (1953), *acq.* 1954-1 Cum. Bull. 4; *Albert Vischia v. Com.*, 26 T. C. 1027 (1956); *Sarah Briarly v. Com.*, 29 B. T. A. 256 (1933); *W. T. Thrift, Sr. v. Com.*, 15 T. C. 366 (1950); *Susie Ackerman v. United States*, 318 F. 2d 402 (10th Cir. 1963).

[34]*Estate of E. P. Lamberth v. Com.*, 31 T. C. 302 (1958), *acq. and nonacq.* 1959-1 Cum. Bull. 4 and 6; *Biscayne Bay Islands Co. v. Com.*, 23 B. T. A. 731 (1931), *acq.* XI-1 C. B. 2; *Key Largo Shores Properties, Inc. v. Com.*, 21 B. T. A. 1008 (1930), *nonacq.* X-1 Cum. Bull. 84; *Ives Dairy, Inc. v. Com.*, 23 B. T. A. 579 (1931), *aff'd* 65 F. 2d 135 (5th Cir. 1933); *Morgan Rundel v. Com.*, 21 B. T. A. 1019 (1930); *Saunders v. United States*, 101 F. 2d 133 (5th Cir. 1939).

[35]Sen. Rep. No. 1622, 83rd Cong. 2d Sess. 64.

taxed as gain the difference between fair market value of the repossessed property and the unexhausted basis in the deferred price obligation.[36] In fact, the Brown Group never did effect a foreclosure-repossession of the mortgaged assets, but instead permitted the Institute to retain and sell them and remit only 90% of the sale proceeds toward the unpaid portion of the original price. [R. 52-57.]

It would be a shocking miscarriage of justice if petitioner were permitted retroactively to interpret respondents' 1953 installment sale into an income retention transaction, in the teeth of many years of general and unqualified tax acceptance of such a sale for installment and capital gain purposes. If petitioner succeeds here, untold numbers of other transactions would also be subjected to *ex post facto* taxation.

E. If a Remedy Is Needed, Congress Should Provide It. Petitioner's Proposal For Court Action Would Take From an Accepted Rule of Tax Law the Reliability That It Deserves for the Future and the Integrity That It Deserves for the Past.

Viewed realistically, petitioner's argument here is a valiant attempt to furnish some support for the Revenue Service condemnation of credit sales to exempt organizations which began with Rev. Rul. 54-420. That ruling gave no legal reason for its position. See last paragraph, Appendix A, p. 5. Petitioner presents no sensible legal reason.

The Treasury recently asked Congress to enact specific legislation which would have been very similar to

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[36]And so it continued under Regs. 1.453-5(b), implementing the 1954 Revenue Code. A 1964 amendment to the 1954 Code has established a new rule for repossession of real estate. Section 1038 as added by P. L. 88-570, Section 2(a).

petitioner's theory. With respect to the 1963 Tax Bill, which became the Revenue Act of 1964, Secretary Dillon proposed to Congress[37] that payments on the sale of a capital asset which were "deferred over more than 5 years and * * * contingent on future income be treated as ordinary income". The purpose was to prevent a taxpayer from enjoying capital gain rates where he continued to possess "the principal right of ownership —participation in the income produced by the asset" or by "the income-producing property underlying the asset sold". He explained that a "payment would be regarded as so contingent on future income if it were contingent on productivity, sales, profitability, use or disposition of the asset sold or the underlying property"; and that his proposal would cover a "sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets".

No such provision was incorporated into the Revenue Act of 1964, although Section 224 of that Act did add Code Section 483, effective with respect to sales made after June 30, 1963, providing for ordinary income taxation of the interest increment of deferred payments. The amendment, says the Committee Report, has taken into account the situation "Where, at the time of the sale or exchange, some or all of the payments are indefinite as to their size; for example where the payments are in part at least dependent upon future income derived from the property * * *"[38]

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[37]Page 91 of the Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, presented to the Ways and Means Committee on February 6, 1963.

[38]General explanation of H. R. 8363, Revenue Bill of 1963 (1964), Report of House Ways and Means Committee, p. 73, Report of Senate Finance Committee, p. 103.

It is evident that:

Congress in 1950 reviewed the subject of credit sales to exempt organizations where the price was to be paid from future income, and enacted specific remedial provisions which respondents relied upon and conformed to in making their 1953 sale;

Congress in 1963-64 reviewed the general subject of credit sales where the price is to be paid from future income, and provided a specific statutory remedy that declined a Treasury proposal like that made here;

Petitioner's proposal here would change the meaning of the statutory word "sale" from the normal commercial meaning it has enjoyed for over 40 years to an esoteric and uncertain meaning that respondents could not have anticipated when they made their 1953 sale.

Under circumstances very similar to those here present, the Treasury's arguments were rejected by this Court in *Hanover Bank v. Commissioner,* 369 U. S. 672 (1962).

This Court noted (p. 687) the "firmly established principle of statutory interpretation * * * that 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.' *Crane v. Commissioner,* 331 U. S. 1, 6 * * *"; said (p. 682) that although the Government's complaint about a loophole "might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place * * * it may not, of course, have any impact upon our interpretation of the statute under review";

and commented (p. 684): "* * * it is worthy of note that Congress understood the operation of the statute to the taxpayer's advantage, but limited correction of the abuses inherent in it * * *".

Remarking (p. 686) that "the language of the statute" and "regulations contained not the slightest hint of the distinction urged" by the Treasury, and (p. 688) that "an informed Congress" had acted "with full realization" of the operation of the stataute "but chose not to make any distinction" of the kind urged by the Treasury, this Court concluded (p. 687): "* * * we are not at liberty, notwithstanding the apparent tax-saving windfall bestowed upon taxpayers, to add to or alter the words employed to effect a purpose which does not appear on the face of the statute." *Accord, United States v. Cumberland Public Service Company,* 338 U. S. 451, 455-456 (1950); *Helvering v. Flaccus Oak Leather Co.,* 313 U. S. 247 (1941).

If the Treasury still wants to provide special rules restricting capital gains for credit sales with price payable from future income, it should renew with Congress the subject of particular amendments to that end.[39] If it wants to narrow the tax benefits available to exempt organizations that make such purchases, it should ask Congress to reconsider the 1950 amendments.

The Treasury should not ask this court to so unsettle the long-accepted meaning of a statutory word as to destroy the future reliability of this Rule of Tax Law, and deprive it of integrity for respondents and others who have depended upon it in the past.

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[39]The generic treatment has been a particular code provision. See Sections 165(g) and 1231-1250 of the 1954 Revenue Code.

Conclusion.

The decision below should be affirmed.

Respectfully submitted,

ARTHUR A. ARMSTRONG,
Attorney at Law.

October 29, 1964.

APPENDIX A.

Rev. Rul. 54-420
1954-2 Cum. Bull. 128

Regulations 118, Section 39.101(6)-1:

Religious, charitable, scientific, literary, and educational organizations and community chests.
(Also Section 421, Section 39.421-1; Section 422, Section 39.422-1; Section 3814, Section 39.3814-1.)

A foundation which acquires all of the outstanding stock of a business corporation, dissolves the corporation and sells, leases, or licenses the assets to an operating company, receiving a substantial portion of the profits of the operating company and using those profits to liquidate the indebtedness incurred in acquiring the business, is not engaged in activities coming within the contemplation of section 101(6) of the Internal Revenue Code of 1939.

If the foundation were otherwise exempt under section 101(6) of the Code, the receipt of rents and royalties by it from the lease and license agreements with the operating company do not fall within the meaning of the exceptions to "unrelated business net income" as set forth in section 422 of the Code, and such rents and royalties would be subject to tax under section 421 of the Code. Moreover, in such a case the provisions of section 3814 of the Code may be applicable on the ground that the foundation is unreasonably accumulating income if it uses a large part of its income to retire indebtedness incurred in the acquisition of income producing property.

Advice is requested whether a foundation is entitled to exemption from Federal income tax under the factual circumstances described below.

The foundation in the instant case was incorporated for scientific, charitable, educational, and religious purposes. The foundation proposes to acquire all the outstanding capital stock of a business corporation, dissolve the corporation, receive the assets and sell, lease or license the assets to an operating company. The operating company will then enter into a management contract with the original stockholder. Part of the current assets will be transferred to the operating company (subject to liabilities), and the remaining assets (exclusive of patents) will be leased to the operating company for a term of 5 years. A part of the consideration to be received by the foundation for the current assets will be evidenced by a promissory note of the operating company, payable without interest on or before the termination of the 5-year lease. The annual rental under the lease will be equal to 10 percent of the annual net income of the operating company before Federal and State income, franchise, excess profits and other similar taxes.

The patents received by the foundation upon liquidation of the corporation will be licensed to the operating company for annual royalties equal to 70 percent of the annual net income of the operating company before such taxes. The period of the license was not definitely fixed and may be in excess of 5 years.

An initial payment to the original stockholder under the agreement will be made from the assets received by the foundation upon liquidation of the corporation and the balance will be paid at the rate of 90 percent of the rental income and royalties received by the foundation for the lease of the fixed assets and the license of the patents.

As security for the note evidencing the unpaid balance under the agreement, the foundation will give the original stockholder a first mortgage on all real estate and buildings and a chattel mortgage on all the other tangible assets received by the foundation, except the current assets transferred to the operating company. As further security, the foundation will give to the original stockholder a conditional assignment of patents, a conditional assignment of the foundation's interests as lessor in the lease and license to the operating company, and the note of the operating company evidencing the consideration received for the current assets. The foundation will have no liability whatsoever for payment of the unpaid balance except out of the assets (including income therefrom) received upon liquidation of the corporation.

Section 101(6) of the Code provides for the exemption from taxation of:

> Corporations and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual. * * *

Under the circumstances of the instant case it is the position of the Internal Revenue Service that the foundation is not engaged exclusively in activities coming within the contemplation of section 101(6) of the Code.

If the foundation were otherwise exempt under section 101(6) of the Code, the amounts termed rents and royalties received by it under the instant lease and license agreements would be considered to be income

from an unrelated trade or business subject to the Supplement U tax imposed by section 421 of the Code. Section 422 of the Code, which excepts royalties and certain rents from the definition of "unrelated business net income," is not applicable to the instant case. Section 39.422-1(b) of Regulations 118 states that whether a particular item of income falls within the meaning of the exceptions, additions, and limitations provided in section 422 of the Code shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment does not qualify as rent for purposes of the exception in section 422-(a) of the Code.

Attention is also called to section 3814 of the Code which denies exemption under section 101(6) of the Code to certain organizations if the amounts accumulated out of their income, which are not actually paid out for exempt purposes by the end of the taxable year, are unreasonable, or if such accumulated income is used to a substantial degree for purposes other than those constituting the basis of the organization's exemption. Where an organization, which claims exemption under section 101(6) of the Code and is not excepted from the provisions of section 3814 of the Code, uses income to retire indebtedness incurred in the acquisition of income producing property or business, thereby increasing its equity, it is accumulating income within the meaning of section 3814. The question as to whether the income accumulated is unreasonable for the

purpose of such section is not one susceptible of resolution by a general statement, but is dependent upon the particular facts and circumstances in each case.

Transactions of the type involved in this case also present a serious question as to the essential nature of the agreement entered into by the foundation. It is the position of the Service that in cases of this general nature, the amounts received from the foundation in fulfillment of the terms of the agreement will not be recognized as proceeds from a sale requiring capital gain treatment.

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

INTRODUCTION

The Respondents hereby adopt the portions of the Petitioner's brief relating to Opinions Below, Jurisdiction and Statute Involved.

QUESTION PRESENTED

Whether the following transfer complies with the sale or exchange prerequisite for long-term capital gain:

> Stockholder S transfers all the stock of Corporation X to Corporation P for an agreed-upon fixed price payable by P over a period of years where: (i) the liability of P to pay the fixed price is limited to income generated by the underlying assets (and proceeds from the disposition thereof), and (ii) P makes no down payment other than from the underlying assets.

or should all payments received by S (in excess of S's basis for the stock) be taxed as ordinary income.

STATEMENT

The pertinency of the various facts has shifted as the theory of the Commissioner has shifted. In the Tax Court, the Commissioner contended the transaction was a sham because of an alleged secret understanding between the taxpayers and the Institute whereunder the taxpayers could artifically trigger a default thereby permitting them to recapture the property at any time (Tr. 59). Because of this sham assertion, the Tax Court set forth the facts in minute detail. In the Circuit Court, the Commissioner abandoned the sham contention but claimed, among other things, that taxpayers, as a practical matter, could recapture the assets. The Circuit Court adopted the detailed findings of the Tax Court in affirming the decision below.

In his brief to this Court, the Commissioner grounds his denial of capital gain upon a theory of "transfer with a retained income interest" (Br. 2). This theory is based entirely upon the lack of down payment from independent sources and lack of personal liability on the part of the Institute to pay the purchase price, thereby making payment of the purchase price dependent upon the future income yield from the property and upon future changes in value.

Under the Commissioner's present theory, many of the details set forth in the extensive Tax Court findings are unimportant, and the pertinent facts may be simply stated. In the following statement and the remainder of the brief, Petitioner is referred to as the "Commissioner," Respondents are referred to as the "taxpayers," and the California Institute for Cancer Research is referred to as the "Institute":

1. Taxpayers transferred all of the outstanding capital stock of Clay Brown & Company and $125,000 principal amount of notes to the Institute in accordance with the provisions of the Basic Agreement dated February 4, 1953 (Exhibit 32-FF, Tr. 197), and in exchange therefor, the Institute issued its promissory note for $1,300,000 (Tr. 39).

2. The Institute made no down payment, and the liability of the Institute to pay the note was limited to the income generated by the underlying corporate assets and proceeds from the disposition thereof. As security for the note, the taxpayers received a deed of trust and chattel mortgage covering the fixed assets. The Basic Agreement spelled out the mechanics whereby the Institute would de-

rive income from the underlying assets for payment on the note. Such mechanics consisted of the following (Tr. 37-44):

(i) The Institute liquidated Clay Brown & Company and took over all the Clay Brown & Company assets subject to the liabilities.

(ii) The Institute leased the fixed assets to Fortuna Sawmills, Inc., for a 5-year term. The lease required Fortuna Sawmills, Inc. to pay rental in the amount of 80% of the net profit before taxes realized by Fortuna Sawmills, Inc.

(iii) The Institute paid upon the note 90% of all rental received from Fortuna Sawmills, Inc.

3. Clay Brown, one of the taxpayers, managed Fortuna Sawmills, Inc. under a management contract until he resigned on October 31, 1954 (Tr. 44, 48). The taxpayers did not own any stock in Fortuna Sawmills, Inc. (Tr. 42).

4. Due to adverse economic factors, the mill was shut down in June, 1957. The lease expired on January 31, 1958 (Tr. 50). Later in 1958, the Institute sold the mill properties to the Highway Department of the State of California in lieu of condemnation. Pursuant to a subsequent agreement between the parties, the Institute paid to the taxpayers 90% of the net proceeds realized by the Institute from the sale of the mill properties to the California Highway Department (Tr. 56).

5. The total amount received by the taxpayers on the note from the Institute was $936,131, including the 90% of the net proceeds from the sale of the mill properties to the California Highway Department Tr. 56).

6. In regard to determination of the purchase price, the Tax Court found that: (i) the price was the result of real negotiating (Tr. 64); (ii) the price was arrived at in an arms-length transaction (Tr. 67); (iii) the price was within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of the corporate assets (Tr. 64); and (iv) the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been paid which would then permit the Institute to convert the property into money for use in cancer research (Tr. 36).

All Section references are references to the Internal Revenue Code of 1954 (26 U.S.C., 1958 Ed.), as amended, unless otherwise specified.

SUMMARY OF ARGUMENT

I

Since the taxpayers converted their Clay Brown & Company stock and notes into $936,131, there was a conversion of capital investment if the stock and notes were worth that amount when transferred to the Institute on February 4, 1953. The Tax Court found the purchase price was a result of real negotiating, and the Institute was properly motivated through a desire to obtain funds for cancer research. Applying the approach outlined in Revenue Ruling 59-60 for valuing the shares of stock of closely-held corporations for estate and gift tax purposes, the Clay Brown & Company stock had a value of more than $1,300,000.

II

Contrary to the assertions of the Commissioner, there are good reasons why owners of a closely-held corporation benefit from the sale of the stock at a price not in excess of its present value even though the purchasers' obligation is limited to the underlying assets.

III

At first blush, the instant transaction may have appearances of a tax avoidance scheme. Analysis of the transaction changes the complexion. The tax benefits claimed for the instant transaction are no different than benefits sought in many corporate buyouts. Minimum achievement in a corporate buyout should produce 48¢ after taxes for payment upon the purchase price per each dollar generated by the underlying assets (assuming a 52% corporate tax rate). The mechanics of the instant transaction were designed to produce 72¢. Payment of the purchase price with dollars containing substantially more than 48¢ may be accomplished in transactions not involving tax-exempt institutions. Accomplishment of the goal is a manifestation of the basic tax principle that every purchaser receives a cost basis which he is entitled to recoup some way at some time.

IV

As long as Revenue Ruling 58-353 represents the law of the land, there is no basis for denying capital gain where the purchase price is dependent upon income generated by the transferred property. The patent transfer cases approved in this Revenue Ruling are classic examples of capital gain treatment accorded payments completely dependent upon future income generated by the

property transferred. Not only are the patent payments reportable by the transferor as capital gain, but the transferee pays no taxes thereon, being able to deduct the payments in full as depreciation.

V, VI

Interrelated provisions of the Code sanction a standard plan for corporate buyouts where payment of the purchase price is dependent upon income generated by the underlying corporate assets. If the instant transaction had been accomplished under the standard plan (which contains many features similar to the instant transaction), the tax consequences at the corporate level would have approximated those of the instant transaction.

VII

A scalpel touch has been applied by Congress to the sensitive tax area here involved through the enactment of Section 1245 in the Revenue Act of 1962. Applicability of the depreciation recapture provisions of Section 1245 is triggered by the liquidating distribution of the acquired corporation, and presents a deterrent to transactions of the instant type as well as transactions under the standard plan.

VIII

Anomalies and complications encountered by the Commissioner in his argument result from features peculiar to the simplified version used as the basis for his argument,—the owner of a dividend-paying, marketable, minority interest in a widely-held corporation who transfers his stock for the right to have the dividends remit-

ted to him. Under the Commissioner's supposition, only 14¢ remains after taxes out of each dollar generated by the underlying assets. Naturally, the transaction lacks economic sense. However, the Commissioner's simplified version has no relationship to the actual facts whereunder the taxpayers sold all the stock in a closely-held corporation.

IX

A possibility that the taxpayers would receive *less* than the agreed-upon price for the Clay Brown & Company stock was the only consequence which could evolve from the lack of down payment and the limitation of the Institute's liability. Yet, such lack of down payment and limitation of liability constitutes the sole basis for the Commissioner's "transfer with income reserved" theory. A possibility that the taxpayers might receive *less* than the agreed-upon price for the stock does not militate against (much less negate) the fact that the taxpayers converted the stock into the amounts actually received. It would be different if the taxpayers received, or could receive, payments substantially exceeding the value of the stock at the time of transfer.

X

Within the last year, Congress has on two occasions expressed its intent concerning capital gain qualification for payments dependent upon future income, once through the addition of Section 483 to the Code (the interest imputation provision), and once by refusal to change the law in the manner requested by the Secretary of the Treasury. A provision in Section 483 would

be unnecessary if the full amount of payments dependent upon future income constituted "transfers with income reserved" as claimed by the Commissioner.

In a statement before the Committee on Ways and Means in the House of Representatives, the Secretary of the Treasury proposed that payments on the sale of capital assets contingent on future income be denied capital gain recognition. He illustrated the status of the present law and the desired change through an example which closely parallels the instant transaction and contains all the adverse features cited by the Commissioner. The Secretary did not say there was an ambiguity concerning the law illustrated by his example, but unequivocally stated capital gain would be accorded the transferor under present law. While Congress adopted the interest imputation provision (Section 483) proposed by the Secretary of the Treasury in the same statement, Congress declined to deny capital gain treatment for deferred payments contingent on future income.

XI

The Commissioner recognizes that the conclusion drawn by him from the oil, gas and mineral cases is inconsistent with recognition of capital gain for patent transfers under Revenue Ruling 58-353. Refusal of Congress to change the law relating to patent transfers puts the Congressional stamp of approval on patent transfers.

XII

Section 1239 recognizes that capital gain should be allowed upon the transfer of a property by an in-

dividual to a corporation in which he owns 80% of the stock. Such transactions are subjected to less interplay of economic forces than the instant one. Yet, the Courts permit capital gain treatment in Section 1239 transactions. Only the portion of the purchase price which may be found excessive is taxed as ordinary income.

XIII

For every transaction of the instant type, there are many transactions utilizing the standard plan whereunder payment of the purchase price is dependent upon income generated by the acquired assets. The Commissioner's position has equal impact upon these transactions. Such purchases, sometimes referred to as "bootstrap" purchases, have been a primary method in the past whereby "have-nots" become "haves." Adoption of the Commissioner's position would preclude such purchases and restrict to those already possessing financial affluence the ability to assure capital gain treatment to sellers.

Congress is aware of bootstrap purchases and their ramifications. Ground rules for such purchases have been affected by the adoption of Section 1245 (depreciation recapture provision) and Section 483 (interest imputation provision). These amendments, coupled with a refusal to deny capital gain treatment for deferred payments dependent upon future income, indicate an unwillingness on the part of Congress to outlaw bootstrap purchases. Rather, Congress has taken the approach of keeping such purchases within bounds through a change in the ground rules.

XIV

The Commissioner's theory is inconsistent with the position taken by him in cases denying a rental deduction to the lessee corporation. If the selling stockholder has really made a transfer with income reserved, the reserved income cannot be taxed to the lessee corporations or anyone else. Yet, as pointed out in the Commissioner's brief, he has met with some success in disallowing rental deductions to the lessee corporations.

Furthermore, if the Commissioner's theory is sustained, a remand to the Tax Court would be required for determination of the depreciation allowable to the taxpayers. The Commissioner's failure to have presented any such matters for consideration by the trial court indicates that his position before this Court is upon a completely different theory.

ARGUMENT

I

The purchase price receivable for the Clay Brown & Company stock was negotiated through arms length bargaining and did not exceed the value of the stock at the time of the sale.

"Conversion of capital investment" is the prime prerequisite for capital gain long recognized by this Court.[1] The Commissioner concedes that:

> (i) Taxpayers transferred their 32,000 shares of Clay Brown & Company stock and $125,000 principal amount of notes to the Institute in accord-

[1] *Burnet* v. *Harmel*, 287 U.S. 103, 106 (1932); *Corn Products Refining Company* v. *Commissioner*, 350 U.S. 46, 52 (1955).

ance with the provisions of the Basic Agreement dated February 4, 1953, and in exchange therefor, the Institute issued its promissory note for $1,300,000 payable to the taxpayers in the manner provided in the note and in the Basic Agreement; and.

(ii) The Institute made payments aggregating $936,131 on the promissory note, and such $936,131 is all the taxpayers have ever received for their stock and the $125,000 in notes.

The net effect of (i) and (ii) is that the stock and notes were converted into $936,131. This constitutes a conversion of capital investment in pure form provided the Clay Brown & Company stock and notes were worth $936,131 at the time of transfer on February 4, 1953.[2]

Ordinarily, when the consideration payable for property is determined through arms-length negotiations, the consideration represents the value of the property at the time of transfer, — the amount of the capital investment. The Tax Court made the following findings which the Commissioner has never questioned:

"The price . . . was the result of real negotiating." (Tr. 64).

"The finally agreed price was arrived at in an arms-length transaction . . ." (Tr. 67).

The price was ". . . within a reasonable range in the light of the earnings history of the corpora-

[2] Taxpayers are not making any point concerning the difference between the $936,131 actually received, and the $1,300,000 purchase price so far as value at the time of transfer is concerned. As hereinafter related, the stock and notes were worth at least $1,300,000 so the difference between the two figures is immaterial.

tion and the adjusted net worth of the corporate assets." (Tr. 64).

"Petitioners by the transaction here involved parted with their equitable ownership of the assets when they transferred their stock to the Institute and became the creditors of the Institute with mortgages and a management contract as security for payment of the purchase price of the stock." (Tr. 60).

"The primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (Tr. 36).

The above findings of the Tax Court were emphasized by the Circuit Court in its affirmance of the Tax Court decision.[3]

Despite his acceptance of the findings related in the preceding paragraph, the Commissioner makes an oblique attack thereon by questioning the significance of the findings through a claim that any bargaining is "economically meaningless" (Br. 36) where the obligation of the transferee to pay the purchase price is limited to in-

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[3] "There was considerable bargaining, at arms length, and a price was agreed upon that was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of its assets." (Tr. 292).

". . . there was a change of economic benefits in the transaction." (Tr. 294).

". . . the primary motivation of the Institute was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property into money for use in cancer research." (Tr. 294).

come generated by the underlying assets with no down payment from independent sources. Under such circumstances, the Commissioner claims the purchase price "must be substantially greater than the present value of the stock or the transferor is a fool . . ." (Br. 56).

The primary factors for determining stock values are the actual value of the underlying corporate assets less liabilities, and the earnings record of the corporation. The starting point in determining the net value of the underlying assets of Clay Brown & Company is the balance sheet of the corporation at January 31, 1953 set forth in the Tax Court findings (Tr. 22). The stockholder equity shown on this balance sheet, plus the $125,000 in notes, aggregated $619,457.[4] Of this amount, $448,471 constituted retained earnings which had been subjected to corporate tax. While the Commissioner often refers to the avoidance of corporate tax under the instant transaction, he mentions nothing concerning the propriety of taxing as ordinary income all sums received by the taxpayers from the Institute (in excess of their basis for the stock and notes) when $448,471 of such amount represents retained earnings of Clay Brown & Company. The $619,457 of stockholder equity shown on the January 31, 1953 balance sheet reflects book values, not actual values. Substitution of appraised values for book values, increases the

[4] The $619,457 is the aggregate of the following contained in the January 31, 1953 balance sheet set forth in the Tax Court findings (Tr. 22): Earned surplus—$448,471.63. Paid in or Capital Surplus—$13,986, Capital Stock—$32,000 and the $125,000 in notes contained in the bonds, notes and mortgages figure of $529,407.60. The $125,000 in notes is set forth separately on the audited financial statement of January 31, 1953 (Tr. 281).

net worth to at least $1,100,000.[5] Therefore, based on the actual value of the underlying assets at the time of the stock transfer, the amount of the taxpayers' capital investment was not less than $1,100,000. This exceeded the $936,131 aggregate amount received by the taxpayers from the Institute as the only consideration for their stock and the notes.

In Revenue Ruling 59-60[6] issued by the Commissioner to outline the approach, methods and factors to be considered in valuing shares of capital stock of closely-held corporations for estate and gift tax purposes, primary consideration is accorded earnings when valuing stocks of companies which sell products or services to the public. A reading of cases[7] involving the de-

[5] The pro forma balance sheet using appraised values instead of book values was enclosed to the Institute under letter dated December 23, 1952 from an officer of Clay Brown & Company. The essence of this letter is related in the Tax Court findings (Tr. 30). The net worth based on appraised values was $1,050,000 before the supplemental appraisal which showed increased values. Also, as found by the Tax Court (Tr. 48), Fortuna Sawmills, Inc. harvested over 20,000,000 feet from the timber interest assigned to it by the Institute which the Institute had received upon the liquidation of Clay Brown & Company. This was substantially more than the 15,000,000 feet estimated on the balance sheet showing adjusted values for assets in determining the before-mentioned $1,050,000 net worth. Also, the amount per 1000 board feet used in determining adjusted values was $8.20 per thousand board feet whereas an independent appraisal as of May 1, 1952 showed a value of $9.00 per thousand board feet. This excess in timber value was $57,000. Such $57,000 plus the $1,050,000 exceeds the $1,100,000, not counting the additional values shown by the supplemental appraisals.

[6] 1959-1 Cum. Bull. 237.

[7] An earnings summary of Clay Brown & Company discloses average annual earnings of $339,000.00 prior to the subject sale (Tr. 35). Capitalization of these earnings at 20% to arrive at stock value equals $1,695,000.00. Neither the Commissioner nor any Court has attempted to capitalize earnings to arrive at stock value by use of a capitalization rate higher than 20%. *Laird et al,*

termination of stock values based on a capitalization of earnings approach makes it clear that the Commissioner would assert (and probably sustain) a value of more than $1,175,000 for the Clay Brown & Company stock ($1,300,000 less the $125,000 promissory notes) if he were valuing same on February 4, 1953 for estate or gift tax purposes. A value appropriate for gift and estate tax purposes is not excessive for purposes of the "conversion of capital investment" prerequisite for capital gain.

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38 B.T.A. 926 (1938) (Commissioner attacks the capitalization rate approximating 12% utilized by the petitioners as being too high.); *Wishon* v. *Anglim*, 42 F. Supp. 359 (D.C.N.D. Cal. 1941) (Court utilizes 6% capitalization rate); *Estate of L. J. Burda*, 2 T.C.M. 497 (1943) (Commissioner utilizes 10% capitalization rate); *Estate of Lizzie F. Olney*, 5 T.C.M. 503 (1946) (Commissioner utilizes capitalization rate approximating 9%); *Estate of William S. Cherry*, 5 T.C.M. 495 (1947) (Commissioner utilizes 10% capitalization rate); *Estate of J. B. Davis*, 5 T.C.M. 1064 (1947) (Court upholds Commissioner's determination by utilizing 14½% capitalization rate); *Bader* v. *U. S.*, 172 F. Supp. 833 (D.C.S.D. Ill. 1959) (The Commissioner asserts a capitalization rate approximating 7%). In *Kline* v. *C.I.R.*, 130 F.2d 742 (3d Cir. 1942) the court states (at 745):

> "The value of a stock is put by many conservative authorities at 10 times its annual earnings. Other authorities set the value of a stock at 12 to 15 times its annual earnings. Some stock, considered sound, today sell at 25 times their annual earnings."

In *Florence M. Harrison*, 17 T.C.M. 776 (1958) the court preceded the above quote from *Kline* v. *C.I.R.* with the following comment (at 779):

> "A method frequently adopted by the Courts, confronted with the problem of evaluation of stock, is to capitalize the earning rates varying from 6% to approximately 10%."

Capitalization of average annual earnings of Clay Brown & Company at 6% to arrive at stock value would generate a value of $5,550,000.00. Capitalization of such earnings at 10% generates a value of $3,390,000.00. If such earnings were capitalized at the highest rate (approximately 15%) utilized by the Commissioner or any court, the value of the stock of Clay Brown & Company would approximate $2,200,000.00. To repeat, capitalization of Clay Brown & Company earnings at 20% to arrive at stock value generates a value of $1,675,000.00.

II

An owner of all the stock in a closely-held corporation need not be a fool to sell his stock in a transaction whereunder payment of the purchase price is dependent upon future income generated by the underlying assets, although motivation for such sale may be lacking in the case of the stockholder depicted by the Commissioner in his simplified version of the transaction.

Since the taxpayers *did* transfer the Clay Brown & Company stock and notes for the right to receive an amount not in excess of their value at the time of transfer on February 4, 1953, the taxpayers were fools (the only alternative offered by the Commissioner), or there is some fallacy in the Commissioner's thesis that a stockholder has nothing to gain from a sale to a purchaser whose liability is limited to the underlying assets.

The starting point is whether a sale on a deferred basis has attraction for a stockholder *irrespective* of how payment of the deferred purchase price will be funded. If a sale on a deferred basis has little attraction to a stockholder under any circumstances, no amount of financial responsibility on the part of the purchaser will cure the lack. For example, a deferred-payment sale would not offer much to "A" in the Commissioner's supposition (Br. 30-31) since A's stock is traded over-the-counter, and A can sell his stock for all cash any time he desires. On the other hand, if a sale of stock on a deferred basis has attraction to a stockholder, should the stockholder reject the benefits of the sale merely because the purchaser is unable to furnish

personal liability or a substantial down payment? The Commissioner is letting the tail wag the dog. The only adverse consequence which can evolve from the purchaser's limitation of liability is the possibility the seller may not receive all of the purchase price. Where the seller is entitled to receive payment in full before the purchaser derives any substantial benefits, the risk is not as severe as the Commissioner infers.

It is really a question of emphasis. The Commissioner throws the spotlight on the lack of down payment and limitation of liability (Br. 31). With the spotlight thus focused, the Commissioner asks who in his right mind would sell under such circumstances, and supplements his query with a supposed set of facts under which the owner of a marketable security would have nothing to gain even upon a deferred sale to a person furnishing personal liability. Naturally, the stockholder, who has nothing particularly to gain from a deferred sale under any circumstances, would not sell with the spotlight focused on the lack of down payment and limited liability. A change of situation and emphasis produces an entirely different picture. There are many advantages (both tax and non-tax) to be derived from the sale of stock in a closely-held corporation upon a deferred-payment basis.[6] With the spotlight focused on

[6] A number of the advantages are enumerated in the brochure presented by the Institute to Clay Brown (Tr. 172-173). The Commissioner's brief sets forth a partial quotation from the brochure. The advantages quoted by the Commissioner in his brief are only the income tax advantages. He deletes from his quotation the other advantages recited in the brochure which are: the elimination of the risk that after the death of the owners, the business may be subjected to a forced sale or liquidation

these advantages, should a purchase offer be rejected because the one making the offer cannot, for good cause, become personally liable to pay the purchase price or make any down payment from independent sources?

III.

The tax benefits claimed for the instant transaction are no different than the tax benefits sought in many corporate buyouts.

The tenor of the Commissioner's brief is expressed in the following quotation from his introduction (Br. 26):

> "That there is *something* wrong with a transaction for which such extraordinary tax benefits are claimed seems apparent. The difficulty lies in identifying precisely what is wrong . . ."

Are the tax benefits claimed for the instant transaction really "extraordinary," or are the same benefits sought in many corporate buyouts not involving tax-exempt institutions?

Every business is expected to pay for itself. One manifestation of this expectation is a corporate buyout whereunder the purchase price is paid from income generated by the underlying assets of the acquired corpor-

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at possible disastrous loss to the families; avoidance of the risk of the buiness being ruined by incompetent management if sold to others for payment on an installment basis; and protection of the family from estate and inheritance taxes. Under the contentions made by the Commissioner before the Tax Court, it was not considered material why the taxpayers sold their stock to the Institute. This question was not asked Clay Brown either by counsel for the Commissioner or counsel for the taxpayers. The fact remains that they *did* sell for a price representing the value of the stock and notes at the time of transfer.

ation. If each dollar generated by the underlying assets for payment upon the purchase price is taxed at a corporate rate of 52%, only 48¢ remains after taxes out of each generated dollar. It takes longer to pay the purchase price with 48-cent dollars than with 100-cent dollars. An obvious goal is payment of the purchase price with dollars containing as many cents in excess of 48 as possible. The mechanics specified in the Basic Agreement (liquidation of Clay Brown & Company into the Institute and lease of the assets to Fortuna Sawmills, Inc.) were designed to produce 72-cent dollars for payment upon the purchase price out of each dollar generated by the underlying assets.[9]

Payment of the purchase price with dollars containing substantially more than 48 cents after taxes is not the dream of an alchemist. The plausibility of attaining the goal stems from the fundamental proposition that every purchaser receives a tax basis for property equal to his cost which he is entitled to recoup in some way at some time without payment of tax upon the recoupment. One way of recouping basis is through depreciation. Depreciation is an income tax deduction which does not require a cash outlay. For example, if a corporation has $100,000.00 of income and $50,000.00 of depreciation, the corporation has $50,000.00 of net taxable income ($100,000.00 less $50,000.00) subject to a $26,000.00 tax (52% of $50,000.00) leaving $74,000.00 available for expenditure upon the purchase

[9] Fortuna Sawmills, Inc. retained 20c out of each dollar generated by its operations and paid 80c to the Institute. The Institute retained 18c (90% of the 80c) and paid the remaining 72c upon the note.

price, i.e.—74-cent dollars as contrasted to 48-cent dollars.[10]

Where payment of the purchase price for depreciable property coincides exactly with the economic life of the acquired property, the exact amount reportable as capital gain by the transferor is deductible by the transferee, with the result that no tax is incurred by the transferee on the amounts paid to the transferor. Classic examples of transactions of this type are reviewed under the next heading. The problem is more difficult when the seller is not willing to defer receipt of the purchase price over the remaining useful life of the property, but desires payment from income generated by the underlying assets as quickly as possible. The instant transaction falls within this category, as do corporate buyouts under the standard plan discussed under Point V below.

While any corporate buyout should produce 48¢ for payment upon the purchase price out of each dollar generated by the underlying assets, a little misguidance can result in 14-cent dollars. For example, A purchases all of the stock of X Corporation from S and pays the purchase price with after-tax net income extracted from X Corporation as dividends. The 48¢ of X Corporation income remaining after a 52% corporate tax is subject to a 70% individual tax rate when received by A as dividends. The 48¢ less the 70%

[10] The technical term for the $74,000 is "cash flow" or "cash income". Cash flow is net income after taxes plus deductions not requiring cash outlays such as depreciation and depletion. The references in this brief to income generated by the underlying assets means cash flow rather than net income after depreciation.

individual tax leaves but 14.4¢ after taxes for payment by A upon the purchase price. As pointed out later, the "simplified version" of the transaction used by the Commissioner as the basis for his argument is a transaction falling within this 14-cent dollar category.

Admittedly, the tax benefits sought for the instant transaction under the Basic Agreement were: (i) capital gain treatment for the payments received by the taxpayers on the $1,300,000 note evidencing the consideration payable for the Clay Brown and Company stock; and (ii) payment of the purchase price for the Clay Brown & Company stock with 72¢ out of each dollar generated by the underlying corporate assets. A showing that these tax benefits are sought in ordinary transactions sanctioned by the Internal Revenue Code should serve to bring the transaction into the proper perspective which prompted the decisions of the Tax Court and the Circuit Court below, and prompted capital gain recognition by all other courts which have reviewed similar transactions.[11]

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[11] *Union Bank* v. *United States*, 285 F.2d 126 (Ct. Cls. 1961); *Anderson Dairy, Inc.*, 39 T.C. 1027 (1963); *Royal Farms Dairy Co.*, 40 T. C. 172 (1963); *Singer*, 22 T.C.M. 759 (1963); *Isis Windows, Inc.*, 22 T.C.M. 837 (1963); *Stahl*, 22 T.C.M. 996 (1963).

IV

Patent transfers covered by Revenue Ruling 58-353 present classic examples of an exact correlation between recoupment of cost basis and payment upon the purchase price reportable by the transferor as capital gain and classic examples of consideration dependent upon future income. A Code provision sanctions such tax consequences even though the transferee is a corporation in which the transferor owns 80% of the stock.

Capital gain treatment for the following transaction is confirmed by Revenue Ruling 58-353[12] under the general capital gain provision of the Code here involved.[13] S, owner of a patent which he purchased from the inventor, grants Corporation X an exclusive license to use, manufacture and sell under the patent during the remaining fifteen year life of the patent. In consideration of such transfer, Corporation X agrees to pay S royalties equal to a specified percentage of the net profit realized by X from exploitation of the patent. The agreement permits S to recapture the patent and terminate the rights of Corporation X upon failure of X to pay specified minimum amounts.

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[12] 1958-2 Cum. Bull. 408.

[13] Section 1235 applies to the sale or exchange of patents by the inventor or any other individual who has acquired his interest in the patent for consideration paid to the inventor prior to actual reduction to practice. The situation depicted in the supposition is beyond the scope of Section 1235 because S was not the inventor and did not obtain his interest through consideration paid to the inventor prior to the actual reduction to practice. The cases covered by Revenue Ruling 58-353 are in this latter category of situations beyond the scope of Section 1235. As indicated by the cases cited in the Revenue Ruling, Section 1235 is not deemed exclusive and failure to come within Section 1235 does not preclude capital gain recognition under the general capital gain provisions.

Not covered by Revenue Ruling 58-353, but equally important to the overall transaction, is the right of Corporation X to deduct as depreciation the full amount of the royalties paid to S. Such right is confirmed by the Commissioner's published acquiescence in the case of *Associated Patentees, Inc.*, 4 T. C. 979 (1945).[14] Ability of Corporation X to deduct the royalties from ordinary income as and when paid to S means that the royalties paid to S are not subjected to X's corporate income tax. This is not tax avoidance, but is a manifestation of the axiom that every purchaser receives a basis for property equal to the purchase price which he is entitled to recoup tax free in some way, at some time. Here, the tax recoupment of basis through depreciation deductions coincides exactly with payments upon the purchase price.

Not only do the patent transfers covered by Revenue Ruling 58-353 represent classic examples of an exact correlation between recoupment of cost basis and payment upon the purchase price, but such transfers are classic examples of consideration dependent upon future income of the property transferred. The consideration for such transfers is *completely* dependent upon future income because the amount of the consideration is measured by the future income derived by the transferee from the use of the patent. As long as Revenue Ruling 58-353 represents the law of the land, there is no ground for the Commissioner's contention that cap-

[14] In 1946-1 Cum. Bull. 1, the Commissioner published his acquiescence in result only to *Associated Patentees, Inc.* The Commissioner in 1959-2 Cum. Bull. 3 withdrew his acquiescence in result only and substituted his acquiescence.

ital gain recognition should be denied the taxpayers because payment of the consideration for the Clay Brown & Company stock was dependent upon future income derived from the underlying corporate assets. As related under point X, a refusal by Congress to adopt a proposal of the Secretary of the Treasury reversing the law of Revenue Ruling 58-353 unequivocally confirms that the law set forth in Revenue Ruling 58-353 is in accord with Congressional intent.

The cases cited in Revenue Ruling 58-353 accord capital gain treatment to S even though S owns up to 80% of the stock of X Corporation. Revenue Ruling 58-353 refers to Section 1239 which denies capital gain treatment upon the sale of depreciable property to a corporation in which the transferor owns more than 80% of the stock. By denying capital gain treatment upon a sale to an 81% owned corporation, Section 1239 recognizes that capital gain is allowable where the transferor's stock interest in the transferee is less than 80%.[15] Ownership of stock in the transferee is a substantial tax benefit. The taxpayers did not own any stock in the Institute or in Fortuna Sawmills, Inc.

Ability of the transferor to own up to 80% of the stock of the transferee negates the Commissioner's suggestion that an independent expenditure of effort and money by the transferee in patent cases may be a distinguishing feature. The sawmill and other activities of Clay Brown & Company could not run themselves after the transfer of the stock to the Institute. True,

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[15] Section 1239 applies to all depreciable property, not patents alone.

Clay Brown was the manager of Fortuna Sawmills, Inc. until his resignation on October 31, 1954. However, it is not uncommon for a controlling stockholder to install himself as director and chief executive officer of his 80%-owned corporation. The control which Clay Brown could exercise over Fortuna Sawmills, Inc., through his management contract was mild in comparison with control exercisable by an 80%-stockholder.

V

There is a standard plan for corporate buyouts where payment of the purchase price is dependent upon income generated by the underlying corporate assets. This plan, sanctioned by interrelated provisions of the Code, has features and tax consequences identical to the instant transaction.

Stockholder S owns all the stock of X Corporation which S believes is worth at least $1,300,000. P desires to purchase Corporation X, but has nothing like $1,300,000. Due to P's limited resources, payment of the purchase price will be dependent upon income generated by X's assets. S is willing to entertain a purchase offer if the business can pay off the purchase price over a reasonable period of time. This is not an unusual situation. A typical example is the industrious employee who desires to buy out his employer.

Only 14-cent dollars will be available to P from income generated by the underlying assets if P purchases the X stock and pays the purchase price from after-tax income of X distributed to P as dividends.[16] There

[16] As related supra, the 48c of X Corporation income remaining after 52% corporate taxes is subject to a 70% individual tax

is, however, a standard corporate buyout plan which not only eliminates the necessity for dividend extraction to pay the purchase price but increases the cash flow generated by the underlying assets over the cash flow available to X Corporation. This standard plan is outlined below:

1. P forms new corporation, Y. Y Corporation (not P) purchases the X Corporation stock from S. Y Corporation obligates itself to pay the agreed-upon price of $1,300,000 for the X stock. The obligation of Y Corporation to pay the purchase price for the X stock is evidenced by Y's promissory note payable to S over a period of years.

2. X Corporation is immediately liquidated into Y. Corporation with Y taking over all of the assets and liabilities of X. Upon receipt of the X assets, Y Corporation grants a mortgage thereon to S securing the $1,300,000 note. The stock of Y Corporation might be deposited in escrow as additional collateral security for the note. Y Corporation pays the note out of income generated from its ownership and operation of the former X assets.

The following tax consequences flow from the standard plan under the indicated Code provisions.

(a) No gain is recognized to X Corporation on the distribution of its assets to Y Corporation as liquidating distributions (Section 336).

(b) Y Corporation obtains an immediate $1,300,000 cost basis for the X Corporation stock

when received as dividends, and the 48c less the 70% individual tax leaves 14.4c after taxes for payments by P upon the purchase price.

(Section 1012).[17]

(c) No gain is recognized to Y Corporation upon the receipt of the X assets as liquidating distributions (Section 332).[18]

(d) Y Corporation receives a basis for the X assets equal to its $1,300,000 cost basis for the X stock plus the amount of X Corporation liabilities taken over by Y upon the liquidation of X into Y. Such transfer of Y Corporation's $1,300,000 basis for the X stock to the underlying corporate assets is accomplished through Section 334(b)(2).[19] The basis is allocated among the assets in accordance with relative actual values.[20]

(e) S elects the installment method under Section 453 and reports his gain proportionately as and when he receives payments from Y Corporation on the $1,300,000 note. Section 453 expressly permits reporting of gain on the installment me-

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[17] Treasury Regulation Section 1.1012-1 provides:

"In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash *or other property*." (Emphasis supplied).

It might be argued that the basis of the property in the hands of the purchaser is the purchaser's equity in the property on the theory that the note given by the purchaser does not constitute other property. The Commissioner made such an argument in an analogous situation in *Crane* v. *Commissioner*, 331 U.S. 1 (1947). This Court rejected the Commissioner's position mainly because of the bearing such construction would have on the allowance of deductions for depreciation and adjustments of basis.

[18] Y Corporation would not have any gain upon the liquidation even in the absence of Section 332 since Y Corporation has a cost basis of $1,300,000 for the X Corporation stock so the net value of the X Corporation assets would not exceed this basis.

[19] Section 334(b)(2) is a codification of the holding in *Kimbell-Diamond Milling Co.*, 14 T.C. 74 (1950), affirmed 187 F.2d 718 (1951), Cert. Den. 342 U.S. 847 (1951).

[20] Treasury Regulation Section 1.334-1 (c)(4)(viii).

thod even though no payments are received during the year of sale.

(f) The income generated by Y Corporation's operation of the former X assets is not taxed as a dividend to P (or anyone else) when paid upon the $1,300,000 note. Since the obligor on the note and the owner and operator of the assets are one and the same, no dividend distributions are required.

VI

Difference between instant transaction and standard buyout plan is one of mechanics. Buyout of Clay Brown & Company under standard plan would produce 70-cent after tax dollars the first year.

The instant transaction differs from the standard corporate buyout plan outlined above only in that the purchaser (the Institute) derived income from the underlying assets through a lease of the assets to Fortuna Sawmills, Inc. instead of a direct operation of the business. The difference is one of mechanics. Contrary to the "treasury raid" innuendoes made by the Commissioner, 80% of the profit paid by Fortuna to the Institute in the form of rental would not have been subjected to corporate tax if the Institute had been a taxable entity. Such corporate tax would be diminished through the benefits of basis allocation under Section 334(b)(2) in the following manner.

The $1,300,000 cost basis for the Clay Brown & Company stock exceeded the book net worth of Clay Brown & Company by $680,000.[21] At least $600,000 of

[21] As reviewed in footnote (4), the book net worth of Clay Brown & Company at January 31, 1953 shown on the balance sheet set forth in the Tax Court findings (Tr. 22) was $619,457. The $1,300,000 exceeds this book net worth by a shade over $680,000.

this excess could have been allocated to depreciable and depletable property;[22] with the result that a taxpaying corporate purchaser would have $600,000 of depreciation and depletion deductions more than the deductions which would have been available to Clay Brown & Company upon a continuation of the business by it. The $600,000 additional basis is over and above (not in lieu of) Clay Brown & Company's net book value for plant, equipment and timber in the amount of $570,000, shown on the balance sheet.[23] This $570,000 basis, plus the $600,000 additional basis, makes available $1,170,000 in depreciation and depletion deductions over the remaining useful life of the property which the Institute could apply against the rental paid by Fortuna.

Operation of the business by the Institute would have subjected the profits to corporate income tax as unrelated business income under Section 511 et seq. In turn, the Institute would be entitled to its depreciation deductions. Such $1,170,000 in depreciation and depletion is dormant when the Institute applies its tax

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[22] In basis allocation under Section 334(b)(2), book value is ordinarily allocated to cash and the equivalent of cash such as accounts receivable and inventory so none of the $680,000 would be absorbed by the cash, receivables or inventories shown on the January 31, 1953 balance sheet (Tr. 22). The only non-depreciable asset is the land, and the $80,000 is more than ample to allow for any appreciation which had occurred in the land, leaving the $600,000 for allocation among the building, equipment, facilities, furniture and fixtures, and timber. A more detailed breakdown of the assets than that shown on Tr. 22 is contained in the audited balance sheet at January 31, 1953 (Tr. 280).

[23] The $570,000 figure is the rounded total of the capital assets and timber shown on the January 31, 1953 balance sheet (Tr. 22). In an actual allocation of basis under Section 334(b)(2), the total purchase price plus the total liabilities assumed are allocated among the assets which produces the same net result as shown in the above review.

exemption to the rental received from Fortuna Sawmills, Inc.

Suppose the transaction were handled under the standard corporate buyout plan. How many dollars would be available for payment upon the $1,300,000 note for each dollar of income generated by the underlying corporate assets? The following realistic assumptions are used in the computations: The assets conservately have a depreciable basis of $1,000,000. The remaining useful life of the depreciable assets is 10 years.[24] The earnings are $350,000 a year before depreciation and taxes. The declining balance method of depreciation (1½ times) is used. Based on these assumptions, each dollar generated by the underlying corporate assets would produce the following number of cents after taxes available for payment upon the purchase price: 70¢ the first year, 67¢ the second year, 64¢ the third year, 62¢ the fourth year and 60¢ the fifth year, or composite for the 5-year period of 65¢.[25]

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[24] Revenue Procedure 62-21, 1962-2 Cum. Bull. 418 setting forth guide lines for depreciation specifies a useful life of 10 years for a sawmill and its equipment. There is no salvage value required under guide line lives since the period specified takes depreciation into account. That is, a 10-year useful life is the same as a 9-year useful life with 10% salvage. The guide lines specify 10 years with no salvage, rather than 9 years with 10% salvage.

[25] These figures are computed as follows:

	1st year	2nd year	3rd year	4th year	5th year
1. Earnings before depreciation	350,000	350,000	350,000	350,000	350,000
2. Depreciation	150,000	127,500	108,375	92,120	78,305
3. Taxable income	200,000	222,500	241,625	257,880	271,695
4. Tax - 52%	104,000	115,700	125,645	134,100	141,280

As previously stated, the objective of the Institute-Fortuna Sawmills, Inc. lease arrangement was the production of 72¢ for payment upon the purchase price out of each dollar generated by the assets. Production of 70¢ the first year and a composite of 65¢ for a 5-year period may not equal the 72¢ of the instant plan, but it comes quite close and the difference does not represent any "extraordinary" tax benefits.

Total depreciation of $556,300 was consumed during the five years covered by the above illustration which would leave $443,700 of depreciation available during subsequent years. If a remaining useful life of seven years (rather than ten) could be sustained for the depreciable assets, each dollar generated by the underlying corporate assets would produce 80¢ the first year, 73¢ the second year, 68¢ the third year, 63¢ the fourth year and 60¢ the fifth year, or a composite for the 5-year period of 69¢.[26] Depreciation is not the only method for recouping tax basis without payment of tax thereon. The difference between $1,300,000 purchase price in the illustration and the $1,000,000 allocable to the depreciable assets is not

5. Net income	96,000	106,800	115,980	123,780	130,415
6. Add back depreciation	150,000	127,500	108,375	92,120	78,305
7. Cash income	246,000	234,300	224,355	215,900	208,720
Cents of cash income per dollar generated (ratio between line 7 and line 1)	70.3	67.0	64.1	61.7	59.6

[26] These figures are computed in the same manner as set forth in footnote 25.

lost but is absorbed as the basis for the accounts receivable and inventory. Any reduction in accounts receivable or inventory will produce tax-free dollars. As previously stated, this is all a manifestation of the basic tax principle that a purchaser is entitled to recoup the cost basis for property without payment of tax on the recoupment. Utilization of this basic principle is overlooked when the Institute's tax exemption is utilized. The erroneous inference is created that all income to which the exemption is applied would otherwise be taxable.

VII

Congress has not been dilatory in its surveillance of the tax area encompassed by the standard corporate buyout plan and by transactions of the instant type.

An avenue of possible abuse under the standard buyout plan has been closed through Section 1245 (added to the Code by the Revenue Act of 1962).[27] As related in the standard buyout plan, Corporation Y is entitled under Section 334(b) (2) to step up its basis for the assets to reflect the $1,300,000 purchase price payable by Y for the X stock, without any corresponding gain to X Corporation upon the liquidating distribution of the X assets to Y. In certain instances, the spread between X Corporation's basis for the depreciable assets and the stepped-up basis attainable by Y Corporation may be attributable to the aggresive depreciation policy of X Corporation, rather than any appreciation in value of the assets. Since X

[27] Revenue Act of 1962, Section 13(a); 76 Stat. 960.

Corporation previously enjoyed substantial depreciation deductions, an undue tax advantage might result when Y Corporation obtains ordinary deductions through depreciation of the same assets on the stepped-up basis without any corresponding tax detriment, except the capital gain tax to S. Section 1245 taxes as ordinary income the gain realized upon the sale or other disposition of depreciable property to the extent of depreciation taken after December 31, 1961. Dispositions covered by Section 1245 include liquidating distributions.[28] If X Corporation had taken $300,000 of depreciation after December 31, 1961, Section 1245 would charge Corporation X with $300,000 of ordinary income, and the tax liability resulting therefrom would be one of the obligations taken over by Y Corporation.

Section 1245 will apply to transactions such as the instant one. The triggering event for application of Section 1245 is the liquidating distribution of the assets by the taxpaying acquired corporation, so the tax-exempt status of the distributee does not immunize the transac-

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[28] Section 1245 (a)(1) provides:

"Except as it otherwise provided in this section, if section 1245 property is disposed of during a taxable year beginning after December 31, 1962, the amount by which the lower of—

(A) the recomputed basis of the property tax, or

(B)(i) in the case of a false sale, exchange or involuntary conversion, the amount realized, or

(ii) *in the case of any other disposition, the* fair market value of such property,

exceeds the adjusted basis of such property shall be treated as gained from the sale or exchange of property which is neither capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle. * * *" (Emphasis supplied).

A liquidating distribution constitutes a disposition of property.

tion from Section 1245. Section 1245 represents a scalpel touch applied by Congress to a sensitive tax area under its continuing surveillance. As later pointed out, Congress is well aware that selling stockholders claim capital gain where the payment of the purchase price is dependent upon future income derived from the business.

VIII.

Features peculiar to the Commissioner's "simplified version" account for the complications encountered by him, and for his assertion that the transaction makes no economic sense. The taxpayers present an unbiased simplified version.

In the simplified version of the transaction used by the Commissioner as the basis for his argument, the amounts paid to the transferor stockholder are derived by an individual transferee from the underlying corporate assets through dividend distributions which are then remitted to the transferor (Br. 30-31). In such a transaction each dollar generated by the underlying corporation assets is subjected to the 52% corporate tax, and the 48¢ remainder when taxed to the individual transferee as a dividend (at a 70% rate) leaves only 14.4¢ for payment to the transferor. The Commissioner's assertion that the transaction makes no economic sense is a natural reaction to an arrangement whereunder each dollar generated by the underlying assets produces a mere 14.4¢ after taxes for payment on the purchase price.

The only suggestion made by the Commissioner for alleviating the prohibitive tax cost under his simplified

version is the use of a tax-exempt entity as purchaser and recipient of the dividends (Br. 34). This solution precludes the dividend tax, but leaves each generated dollar subject to the full corporate tax, resulting in 48-cent dollars (assuming a 52% corporate rate). The Commissioner fails to indicate that the dividend difficulties can be avoided through the simple expediency of eliminating the necessity for the dividends,—liquidation of the acquired corporation into a corporate purchaser per the standard corporate buyout plan which permits the corporate purchaser to pay the purchase price directly out of income generated by the underlying assets. Neither does the Commissioner mention that such liquidation would step up the basis for the underlying corporate assets thereby reducing the purchaser's corporate tax through increased depreciation and other deductions.

All bridges between the Commissioner's self-imposed complications and Code-sanctioned solutions are burned by the specification in his key supposition that the stock being transferred is a *minority* interest in a *widely-held* corporation (Br. 30-31). A minority stockholder of a widely-held corporation cannot follow the liquidation route. The facts are that Clay Brown & Company, a *closely-held* corporation, *was* liquidated into the purchaser, and the sums paid to the taxpayers were *not* extracted as dividends.

Taxpayers' frequent reference to liquidation of the acquired corporation into the purchaser should not be interpreted as a contention that liquidation has inde-

pendent capital gain significance, such as may be the case for stock redemptions.[29] Under taxpayers' version of the transaction, liquidation is merely one step of a plan whereby income derived from the underlying corporate assets may be paid upon the purchase price in a manner which makes economic sense and avoids the anomalies encountered by the Commissioner under his divided suppositions.

There is merit in the Commissioner's desire to "close off the transaction after the first step" (Br. 29), if such can be accomplished in a manner which neutralizes the subsequent steps without prejudicing the issues. An unbiased neutralization of the subsequent steps is not accomplished by a version which employs "dividends" as the means of extracting income for payment upon the purchase price. No word in the English language has greater ordinary income connotations than "dividend."

The following is proposed as an appropriate simplified version of the transaction.

> Stockholder S transfers all the stock of Corporation X to Corporation P for an agreed-upon fixed price payable by P over a period of years where (i) the liability of P to pay the fixed price is limited to income generated by the underlying assets (and proceeds from the disposition thereof), and (ii) there is no down payment other than from underlying assets.

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[29] Section 331 assures capital gain treatment in the case of partial or complete liquidations.

IX.

The Commissioner's denial of capital gain is based entirely upon the lack of down payment coupled with the fact that the liability of the Institute to pay the purchase price was limited to income generated by the underlying assets (and proceeds from the disposition thereof). The taxpayers claim that capital gain recognition is not thereby precluded.

A distinction is drawn by the Commissioner between "sales" on the one hand and "transfers with income reserved" on the other hand. According to the Commissioner, the distinction is one of "risk-shifting",—the extent to which the transferor's receipts are dependent upon the future income yield from the property or upon future changes in the value (Br. 52). The Commissioner recognizes that shift in risk is sufficient for capital gain recognition if there has been a substantial down payment, or if there is a personal obligation to pay the purchase price on the part of a solvent entity, even though income generated from the underlying assets is in fact used to make the payments (Br. 53-54). The importance of risk in capital gain determination is no greater than the consequence which may evolve from the risk.

Receipt of a *less* than agreed-upon price for the Clay Brown & Company stock was the only consequence which could evolve from the risk born by the taxpayers attributable to the fact that there was no down payment from independent sources and the fact that liability of the Institute to pay the purchase price was limited to income generated by the underlying assets (and proceeds from the disposition thereof). Why should the

possibility that the transferors may receive less than the agreed upon price preclude a conversion of capital investment to the extent of the amounts actually received? The $936,131.85 received from the Institute is all the taxpayers had to show for the surrender of their Clay Brown & Company stock. The fact that the receipts were less than the agreed upon price makes the conversion of capital investment *more* acute from the taxpayer's viewpoint.

Where persons have *purposely* transferred property for less than the acknowledged value at the time of the transfer, the existence of a sale has never been questioned. In such situations, the problem is how does the transferee account for the bargain portion of his "bargain purchase"? If the purchaser is an employee, the bargain portion is compensation.[30] If the purchaser is a family member, the bargain portion is a gift.[31] Since a conversion of capital investment is not affected by a purposeful transfer at less than the acknowledged value of the property, why should a conversion of capital investment be nullified by the *possibility* that the transferor may receive less than the agreed upon price?

No authorities whatsoever are cited on the pages of the Commissioner's brief where he considers the question "What, then, is the difference between sales and transfers with income reserved?" (Br. 52-59). The decision of this court in *Le Tulle* v. *Scofield*, 308 U.S. 415 (1940), may be pertinent. There the taxpayer was

[30] Treasury Regulation Section 1.61-2(d)(2).

[31] Treasury Regulation Section 1.101-1(e).

attempting to qualify a transaction as a tax-free reorganization. To establish the requisite continuity of interests, the taxpayer argued that certain bonds should be considered as equity because of their terms. This court rejected the contention with the following statements (308 U. S. at 421):

> "We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute."

If there is a difference between a sale and a "transfer with income reserved" it lies in the distinction between payments *for* future income, and payments *from* future income. If the purchase price substantially exceeds the value of the property at the time of transfer, the portion of the purchase price in excess of the value at the time of transfer constitutes a payment *for* future income. On the other hand, if the purchase price is within a reasonable range of the value of the property at the time of transfer, payments received upon the purchase price constitute proceeds from the conversion of capital investment even though payment of the pur-

chase price is *completely* dependent upon future income generated by the property transferred. Such payments are *from income* and not *for* future income. The Commissioner sluffs over this distinction by asserting in a variety of forms that the purchase price, of necessity, will substantially exceed the value of the property at the time of transfer when payment is entirely or even substantially dependent upon future income from the property.

The difference between payment *from* future income and payment *for* future income is illustrated by a comparison of the instant case with *Kolkey* v. *Commissioner*, 254 F.2d 51 (7th Cir. 1958). In *Kolkey*, the taxpayer sold for $4,000,000 on a deferred basis a company worth less than one-half the purchase price. Such a "sale" if allowed to stand would have converted future ordinary income to capital gain. Obviously, the payments were in substantial part *for* future income. Just as obviously, where a realistic purchase price is negotiated for the underlying assets, there is a conversion of capital investment even though the purchase price is payable *from* future income.

X.

Recent indications of Congressional intent confirm the allowace of capital gain treatment where payment of the purchase price is dependent upon future income derived from the property.

Congress has upon two occasions within the last year expressed its intent concerning capital gain qualification for payments dependent upon future income derived from the property transferred, —once through an

amendment to the Code, and once by a refusal to change the law in the manner requested by the Secretary of the Treasury.

Section 483 (added to the Revenue Code by the Revenue Act of 1964, Section 224, 78 Stat. 19) imputes interest upon sales of property even though the agreement between the parties provides for no interest. The purpose and operation of Section 483 are fully set forth in the extract from the Senate Report quoted in the footnote.[32]

Paragraph (d) of Section 483 covers payments indefinite as to time, liability or amount. The Senate Committee Report explains paragraph (d) as follows (S. Rep. No. 830, 88th Cong., 2d Sess., p A466 (3 U.S.C. Cong. & Adm. News (1964):

"Where at the time of the sale or exchange,

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[32] "Under present law, an individual may sell a capital asset on the installment basis without making any specific provisions for interest payments on installments. In such cases, the full difference between the cost or other basis for the property and the sales price usually is treated as capital gain to the seller. The buyer takes as a basis for the property the total sales price paid. * * *

"Your committee agrees with the House that there is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. * * * In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. * * *

"The bill solves the problem referred to above by providing that where property is sold on an installment basis and part or all of the payments are due more than 1 year after the date of the sale or exchange—if no interest payments are specified or if 'too low' interest payments are specified then part of each payment due after 6 months is to be treated as interest rather than as part of the sales price."

S. Rep. No. 830, 88th Cong., 2nd Sess., pp A464-A465 (3 U.S.C. Cong. & Adm. News (1964).

> some or all of the payments are indefinite as to their size: *for example where the payments are in part at least dependent upon future income derived from the property,* the 'unstated' interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is received, taking into account the time interval between the sale or exchange and the receipt of the payment. * * *" (Emphasis supplied).

There would be no need for paragraph (d) of Section 483, if the full amount of payments dependent on future income derived from property were taxable as ordinary income due to noncompliance with the sale or exchange prerequisite for capital gains.

The $1,300,000 note evidencing the purchase price for the Clay Brown & Company stock was payable without interest. As an alternative argument in the Tax Court, the Commissioner contended that some portion of the payments received by the taxpayers represented an interest factor taxable as ordinary income. The Tax Court rejected this contention, which was not presented by the Commissioner upon appeal to the Circuit Court. Section 483 applies to transactions of the instant type occurring after the effective date of the amendment, and imputes interest at the annual 4% rate specified by the Commissioner.[33] For example, payments made at the end of the fifth year following such a sale will be considered 20% interest. Since an Act of Congress was required to adopt the alternative contention of the Commissioner, should not the adoption of his main contention likewise await an Act of Congress?

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[33] Treasury Regulation Section 19.3-1 (temp.).

If there is any doubt after enactment of Section 483 concerning Congressional intent in regard to capital gain treatment for payments contingent on future income, the doubt is eliminated through the refusal of Congress to make the change urged by the Secretary of the Treasury in the following extract of his statement on February 6, 1963, before the Committee on Ways and Means of the House of Representatives: [34]

> "*Deferred payments contingent on future income*
>
> "Pursuant to the President's recommendation that changes be affected in the definitional aspects of capital gains taxation, it is proposed that payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income be treated as ordinary income.
>
> "* * * In the case of contracts for the sale of such assets made after February 6, 1963, where the seller retains a long-term income interest, the proposal would treat as ordinary income, payments contingent on future income from the asset sold, or from the income-producing property underlying the asset sold. * * * For example, the proposal would cover the sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets.
>
> * * * * *
>
> *Example* 1
>
> "S owns all of the stock of M corporation. The stock has an adjusted basis of $75,000 in S's hands. S sells the stock to P for $50,000 cash plus

[34] Hearings before Committee on Ways and Means on H.R. 8363, 88th Cong., 1st Sess., 154 (1963).

> $300,000 payable only out of 75 percent of M corporation's net profits in excess of the first $50,000 of such net profits. Under present law, assuming S would be entitled to cost recovery, he would offset his basis against the downpayment and the first $25,000 of contingent payments and would receive capital gains treatment with respect to all subsequent payments. Under the proposal S would first recover his basis, as under present law, against the downpayment and the first $25,000 contingent payments, but subsequent contingent payments would be treated as ordinary income."

There are striking similarities between the facts of Example 1 and the facts of the instant transaction. In Example 1, S transfers *all* the stock of M Corporation, not a minority interest. This permits the liquidation of M Corporation, thereby precluding the necessity for dividend extractions as the means of applying the net profit upon the purchase price. While Example 1 does not specify the mechanics by which the 75% of profits are paid upon the purchase price, it seems obvious the liquidation route, not the dividend route, is intended.[35]

The $50,000 down payment in Example 1 does not contemplate new money from an independent source, at least not for long. The express statement in Example 1, that the obligation of M Corporation to pay 75% of the profits upon the purchase price does not commence

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[35] If the standard corporate buyout plan were utilized, P would form a new corporation which would carry out the purchase. The formation of a new corporation is not essential, however. P could liquidate M Corporation and carry on the business as a sole proprietorship. P would have no gain upon the liquidation since P has a basis of $350,000 for the M stock, so the value of the assets, less the liabilities, would not exceed such basis.

until the $50,000 down payment has been recouped, makes it immaterial whether the $50,000 was originally taken from M Corporation assets or whether it was temporarily supplied by B, or obtained through a loan on the M assets which would be repaid before commencing payment on the purchase price. Neither is payment of the purchase price under Example 1 backed up by personal liability or other assets since the $300,000 is payable *only* out of 75% of M's net profit.

Example 1 contains all the features cited by the Commissioner for denying capital gain recognition to the taxpayers,—(i) payment of the purchase price entirely dependent upon productivity of the corporate assets, (ii) no commitment of other assets or personal liability, and (iii) no injection of new funds through a substantial down payment (except possibly on a temporary basis).[36] The Secretary of the Treasury did not say there was an ambiguity concerning the law in the Example 1 situations. He unequivocally stated that under present law S would receive capital gain treatment on all payments in excess of basis, and the Secretary requested Congress to *change* the law through adoption of an amendment which would tax all payments to S in excess of basis, as ordinary income.

Congress refused to adopt the proposal for the change in the law illustrated by Example 1. However,

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[36] In citing the lack of a down-payment as grounds for capital gain denial (Br. 56, fn. 30), the Commissioner negates substance to a down-payment to be recouped by the transferee prior to payment of the remaining purchase price. His negation runs contrary to the Secretary of the Treasury's concept of the status of the present law as expressed in example 1.

Congress did not leave S with all of his receipts taxable as capital gain. Section 483 will tax a portion thereof as ordinary income at the annual 4% imputed interest rate. This is a clear indication of Congressional intent that the law should stay as represented by the Secretary of the Treasury in Example 1, subject, however, to the impact of Section 483.

The statement by the Secretary of the Treasury before the Committee on Ways and Means of the House of Representatives contained a second example which reads as follows: [37]

Example 2

"S owns a patent which he purchased from the inventor in 1963 for $100,000. In 1964 S sells the patent to P under a contract providing for payments of $0.20 per unit produced under the patent but no less than $10,000 annually for the 10-year remaining life of the patent. Under the present law, all payments in excess of S's basis would be treated as long-term capital gains (assuming the contract has no fair market value). Under the proposals, a portion of the fixed annual payments of $10,000 would be treated as interest and S would offset his basis against the first $100,000 of both contingent and fixed payments (except to the extent treated as interest). Thereafter, $10,000 per year would be treated as partly ordinary interest income and partly capital gain. The excess over $10,000 in any year would be treated as ordinary income since such excess is contingent on further income."

[37] Hearings before Committee on Ways and Means on H. R. 8363, 88th Cong., 1st Sess. 154 (1963).

Example 2 illustrates the effect of the interest imputation proposal (adopted by Congress in Section 483) and the contingent income proposal (rejected by Congress) upon patent transfers of the type covered by Revenue Ruling 58-353.[38] Example 2 shows how the proposal for interest imputation taxes a portion of the fixed required minimum payments as ordinary income and how the contingent income proposal taxes as ordinary income all the remaining payments based on unit production. By adopting the interest imputation proposal (Section 483), Congress agreed that a portion of the patent payments, both fixed minimum payments and contingent payments based on productivity, should be taxed as ordinary income (to the extent of the imputed interest), but that the balance of the payments, those contingent on future income generated by the patent, as well as fixed minimum payments, should be entitled to capital gain treatment. This refutes the Commissioner's assertions that the cases according capital gain treatment for patent payments contingent upon income generated by the transferee's use of the patent are clearly erroneous (Br. 68). Cases interpreting provisions of the Internal Revenue Code can be erroneous only if the interpretation does not reflect the intentions of Congress. Now, we have definite Congressional indication that the law established in these

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[38] Section 483 (f)(4) expressly excludes the interest imputation application of Section 483 to the sale or exchange of patents under section 1235(a). By limiting the exception from Section 483 treatment to Section 1235 patent transfers, Congress implied that Section 483 would apply to patent transfers of the type covered by Revenue Ruling 58-353. Example 2 portrays a Revenue Ruling 58-353 type patent transfer in that S is not the inventor. Section 1235 primarily applies to inventors (See fn. 13, p. 23).

cases correctly reflect Congressional intent. There can be no stronger indication of Congressional intent than a refusal to change the law where both the present law and the proposed change are clearly presented to Congress.

XI

Congressional approval of capital gain treatment for patent payments contingent upon future income refutes the Commissioner's conclusions based on certain oil, gas and mineral cases.

The Commissioner relies heavily upon certain oil, gas and mineral cases which he believes stand for the proposition that capital gain treatment is denied where payment of the consideration is dependent upon income derived through exploitation of the property by the transferee (Br. 44-47). It is recognized by the Commissioner that the conclusions drawn by him from the oil, gas and mineral cases cannot stand side by side with the holdings in the patent cases covered by Revenue Ruling 58-353 which unequivocally accord capital gain treatment for patent transfers even though payment is based on income derived through the transferee's use of the patent (Br. 62). According to the Commissioner, only one of the two can prevail, and the Commissioner nominates the oil, gas and mineral cases as the deserving survivors (Br. 68).

If an impasse actually exists between the oil, gas and mineral cases cited by the Commissioner and the patent cases covered by Revenue Ruling 58-353, the indications of Congressional intent related under the preceding heading tip the scales in favor of the patent

cases. However, no impasse actually exists because the oil, gas and mineral cases do not support the Commissioner's conclusion.

Only one case cited by the Commissioner involves capital gain. In *Burnet* v. *Harmel,* 287 U.S. 103 (1932), the owner in fee of Texas oil lands granted oil and gas leases for as long as oil or gas should be produced from the lands in return for bonus payments and stipulated royalties measured by the production of oil and gas by the lessee. The taxpayer in *Burnet* v. *Harmel,* recognized that there would be no possibility of capital gain qualification if title to the oil and gas passed to the lessee only upon severence from the leasehold. His capital gain assertion rested on Texas law whereunder oil and gas leases operated immediately upon execution to pass the title to the oil and gas in place to the lessee. This Court held that the peculiarities of Texas law did not control the tax consequences, and that the interest passed to the lessee was more in the nature of a privilege than a transfer of a capital asset. The Commissioner fails to explain exactly what application this holding has to the instant situation.

Of the oil, gas and mineral cases cited by the Commissioner involving percentage depletion, only one concerns the sale of corporate stock, *Helvering* v. *O'Donnell,* 303 U.S. 370 (1938). In this case, the taxpayers sold stock of a corporation owning oil and gas property. The consideration for the stock was one third of the net profit derived from the exploitation of the underlying oil and gas properties. This Court rejected the taxpayer's claim

for percentage depletion. Just such a situation is capsulized in the following extract from the previously-quoted statement by the Secretary of Treasury to the House Ways and Means Committee concerning the proposal for taxing deferred payments contingent on future income (Point X, p. 44):

> "* * * For example, the proposal would cover the sale of the stock in a corporation where payment is contingent on * * * productivity of the corporate assets."

The Commissioner contends that the *O'Donnell* case has in some way been modified by subsequent depletion cases to an extent which would require denial of capital gain recognition under the facts of *O'Donnell* (Br. 47-48 fn. 26). If this is true, why was it necessary for the Secretary of the Treasury to include the above example in his proposal for a change in the law? A sale of stock in a corporation where payment is contingent on productivity of the corporate assets represents the essence of the fact situation in *O'Donnell*. Counsel for the taxpayers have carefully reviewed the cases cited by the Commissioner and find nothing therein which negates capital gain recognition upon the sale of stock in a corporation for a price payable out of income derived from exploitation of the underlying oil and gas properties.

XII.

In transactions where arms-length bargaining is impossible, only the excessive portion of the consideration is taxed as ordinary income, not the full consideration.

As reviewed under Point IV, capital gain is recognized upon a transfer of property by an individual to his own corporation provided the transferor does not run afoul of Section 1239 by owning more than 80% of the stock of the transferee corporation. Arms-length negotiation is not expected between an individual and a corporation in which he owns 80% of the stock (or even 51%). Yet, Section 1239 recognizes that capital gain should be allowed the transferor in such transactions even for depreciable property. The Commissioner and the Courts closely scrutinize these transactions to assure that a proper relationship is maintained between value and purchase price. The situation is well expressed by the Tax Court in *Roy J. Champayne*, 26 T.C. 634 (1956), one of the cases approved by the Commissioner in Revenue Ruling 58-353, which accords capital gain treatment (under the general Code provisions here involved) for transfer of a patent to the transferor's controlled corporation (26 T.C. at 645):

> "Respondent's arguments have been carefully considered together with the entire record. It is recognized that in a situation such as the one before us, where the principal stockholder of a corporation also owns a patent and receives payments out of the sales of the patented article, it is possible for a transaction involving such payments to give

rise to suspicion. But, as has been said before, tax issues cannot be decided on suspicion; they must be decided on the facts of each particular case, taking into account the burden of proof, if any, which may be upon the taxpayer or upon the respondent, as the case may be."

Roy J. Champayne further indicates the penalty to be assessed if the consideration is too high. The excessive portion of the consideration is taxed as ordinary income, not all the consideration. This fitting of the penalty to the alleged rule infraction contrasts with the Commissioner's assertion in the instant case that all the taxpayers' receipts from the Institute (in excess of basis for the stock) should be taxed as ordinary income, not merely the portion thereof which the Commissioner believes may exceed the value of the Clay Brown & Company stock at the time of transfer. Actually, the Commissioner has not stated that he believes the $1,300,000 (much less the amount actually received) exceeds the value of the Clay Brown & Company stock. Rather, he relies entirely upon innuendoes derived from his simplified version of the transaction having no relationship to the actual facts. Even if his innuendoes should be correct, it is one thing to nullify the illegal play (tax the excess as ordinary income as did the Court in *Roy J. Champayne*), but quite another thing to forfeit the whole ball game. The sums received from the Institute are all the taxpayers ever obtained for the Clay Brown & Company stock or the underlying corporation assets. Taxation of all these receipts as ordinary income leaves them with very little to show for their conversion of capital investment.

XIII.

Impact of the Commissioner's position extends far beyond the type of transaction here presented.

For every transaction of the type here involved, there are many corporate buyouts under the standard plan utilizing a thinly financed purchasing corporation where, as a practical matter, the purchase price is payable only out of income generated by the underlying assets and the assets themselves, whether or not such limitation of liability is expressly spelled out in the purchase agreements. Similar situations occur in purchases of real property with no down payment under the laws of most states which prohibit deficiency judgments thereby rendering the purchase price payable only from the asset itself. A label, sometimes attached to such transactions, is "shoestring" or "bootstrap" purchase.[39]

By denying capital gain unless there is a substantial down payment from independent sources or personal liability by a purchaser with adequate finances, the Commissioner is laying down specifications for the type of purchaser who is capable of according capital gain treatment to a seller. The Commissioner's specifications favor those possessing financial affluence,—the "haves" in contrast to the "have-nots". In the past, shoestring or bootstrap purchases have been a primary method whereby "have-nots" become "haves". The "haves" already enjoy certain advantages in the market place by the very nature of their "having". The Commissioner's

[39] Contrary to the inferences of the Commissioner in his petition, a grossly inflated purchase price is not a necessary attribute of a "bootstrap" purchase.

specifications accord them a substantial additional advantage of being the only ones who can assure capital gain to a prospective seller.

The position of the Commissioner militates against *any* deferred-payment sale because a seller runs a risk as to whether the size of the down payment or financial affluence of the purchaser falls within or beyond the shadowy boundary line. The only sure solution would be an all cash sale, or a disposition through the tax-free reorganization provisions of the Code. Use of the reorganization provisions permits a transferor to readily convert his investment into cash only if the security is a marketable security. Larger corporations are more inclined to have marketable securities than smaller organizations. It seems rather anomalous to have anti-trust laws which discourage concentration of business in a few hands through the merger route or otherwise, and at the same time have a tax policy which definitely favors acquisitions by financially affluent purchasers and corporations having marketable securities. Considerable romance will depart from the American economic scene if the "have-nots" cannot compete with the "haves" for the purchase of businesses,—whether the objective of the "have-not" is to provide funds for cancer research, or amass a personal fortune.

Congress is well aware of shoestring or bootstrap purchases, and all their ramifications. Within the past few years, the ground rules for such purchases have been affected by the adoption of Section 1245 (the depreciation recapture provision applicable to liquidating distributions of depreciable property as well as to other dis-

positions), and Section 483 (interest imputation provision). As related above (Point X), Congress flatly declined to adopt the proposal made by the Secretary of the Treasury that capital gain be denied deferred payments dependent upon income generated by the asset transferred. In short, Congress was unwilling to sound a death knell for bootstrap purchases, although it changed certain ground rules applicable thereto. Perhaps such a refusal by Congress is attributable to its awareness of the economic and social implications, not mere caprice.

XIV

The contention by the Commissioner in this Court that the transaction is a "transfer with income reserved" is not consistent with the position he has taken in related cases and requires a consideration of matters not raised by the issues presented in the lower Courts.

The Commissioner argues that the transaction in the instant case is a "transfer with income reserved." (Br. 52). He contends that the taxpayers retained the benefits of future income which is fatal to their claim of capital gain. However, at the same time, the Commissioner makes it clear that he has, in related cases, contended that the rental deduction due the operating company (in this case Fortuna Sawmills, Inc.) should be denied. If such future income is really beneficially owned by the sellers, then it certainly is not the income of the operating company and there need be no contention that a deduction from such income for rental should be disallowed (Br. 25, fn. 14).

The Commissioner seeks support for his theory in

the cases involving transfer of interests in oil, gas and mineral rights. However, one of the principal cases upon which the Commissioner relies makes it extremely clear that if the income is in fact reserved by the transferor, the transferee has no taxable income with regard to such future income. *Thomas* v. *Perkins*, 301 U.S. 655 (1937).

The theory of the Commissioner is novel. More important, it is entirely different from the theory upon which the Commissioner relied in the lower Courts. Admittedly, this new theory, if sustained in this Court, requires the case to be remanded to the Tax Court for additional testimony with regard to the myriad of collateral issues which it raises (Br. 71-77). Such proofs were available had the issue been joined on the Commissioner's present theory at the time of the trial in the Tax Court. However, such proofs were unnecessary because the Commissioner argued that there was, in effect, no transfer made by the taxpayers (R. 58).

It is submitted that the Commissioner substantially departed from the original theory upon which the case was tried contrary to the rule set forth by this Court in *Helvering* v. *Wood*, 309 U.S. 344 (1944); *Helvering* v. *Salvage*, 297 U.S. 106 (1936); and *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415 (1932).

CONCLUSION

For the reasons stated, the judgments of the Court of Appeals should be affirmed.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1964
No. 63

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

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Respondents.

BRIEF AMICI CURIAE.

Question Presented.

Whether an irrevocable transfer of corporate stock, negotiated at arm's length, in consideration of liquidation of the corporation and the transferee's agreement, secured by the corporate assets, to pay a fixed price within a reasonable range, in cash installments over 10 years, constitutes a "sale or exchange" of the stock within the meaning of Section 1222(3) of the Internal Revenue Code of 1954 (and Section 117(a)(4) of the 1939 Code) if the transferee assumes personal liability only for minimum annual payments equal to 90% of its earnings from the business before taxes and depreciation, and substantially exceeding the amount which the corporation could have earned but for the transfer and liquidation.

Statement of Interest of Amici Curiae.

This brief is filed by the undersigned attorneys as friends of the Court, with the consent of the petitioner and respondents. The undersigned attorneys variously represent the taxpayers in the cases of *Anderson Dairy, Inc.*, 39 T. C. 1027; *Royal Farms Dairy Co.*, 40 T.C. 172; *Isis Windows, Inc.*, 1963 P-H T.C. Mem. Dec. ¶63,176, and *Warren Brekke*, 40 T. C. 789, all of which cases are now pending on appeal in the Ninth Circuit Court of Appeals and are being held to await the decision in this case, and University Hill Foundation, a charitable organization affiliated with Loyola University, which was, as petitioner has pointed out (Br. p. 23), a participant in the transactions out of which all the above cases arose.[1] The Commissioner has revoked the tax exemption of University Hill Foundation and proposes to assess deficiencies against it arising from these and other similar transactions. The undersigned attorneys are also concerned, in their capacity as members of the Bar generally, with the serious implications of the theories proposed by the petitioner in this case, as these theories would (if accepted by this Court) adversely affect numerous other taxpayers, in particular those engaged in real estate transactions in California. These parties are joining together in the filing of this single brief amici curiae in order to comment upon the issues involved as they directly affect all the amici curiae, without burdening this Court with a proliferation of briefs.

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[1]The taxpayers in the cases of *Anderson Dairy, Inc.* and *Royal Farms Dairy Co.* are represented by Musick, Peeler & Garrett and Joseph D. Peeler. The taxpayers in *Isis Windows, Inc.* are represented by Willis, MacCracken, Butler & Scheifly and John E. Scheifly. Warren Brekke and University Hill Foundation are represented by Latham & Watkins, Dana Latham and John H. Hall.

Statement of Summary of Argument.

Petitioner has begged the question in this case by analogizing it to an economically meaningless, purely tax-motivated transaction in which a stockholder "sells" his stock to a "buyer" for a grossly-inflated "price" to be paid solely from corporate dividends. This analogy fails for two reasons to reflect the actual issue in the case.

I.

First, petitioner's analogy leaves out of account the fact that the Institute, which purchased respondents' stock and notes, guaranteed to make annual payments on the set purchase price which would be (and were) very substantially in excess of the annual earnings respondents could have enjoyed but for the sale. The buyer felt in a position to give this guarantee because of its tax exemption, but the guarantee was not dependent upon the continued retention of the exemption. It was therefore of no concern to the sellers whether the charity would be exempt and able to finance the purchase out of its earnings, or whether (as petitioner had determined) it was not exempt, and hence will be required to dig deeply into its own pocket to make the required payments and still pay its state and federal taxes. This guaranteed payment of amounts equal to 90% of the Institute's receipts *before* taxes and depreciation provided a substantial economic *quid pro quo* to the sellers by providing acceleration of receipt and a cushion against reduced profits. It made it possible for the buyer to negotiate a sales price which the trier of fact has held was set by arm's-length negotiations on the basis of actual values, and was within a reasonable range in terms of these values. This realistic price

alone furnished sufficient proof that the transaction in fact was not of the category of economically meaningless transactions at substantially excessive prices which petitioner contends "must have" occurred, and negates his contention that the sale was merely a device for transmuting ordinary income into capital gain. The sellers' capital gain treatment (contrary to petitioner's theoretically-based arguments) was a tax benefit they would have been entitled to on *any* installment sale, so that ordinary income treatment of the sales proceeds would be highly unfair to the sellers and a windfall to petitioner. The facts of the case show that the purchase price for the stock (about seven times average after-tax earnings without allowing for the very substantial net worth of the assets) was not unreasonable. The facts in numerous similar cases, in which the prices were also found to be well within a reasonable range, further belie petitioner's theoretically-based conclusions.

Petitioner's approach is at root an attack on the findings of the trier of fact, but instead of attempting the impossible task of proving them clearly erroneous on the evidence, he seeks to brush them aside because they are irreconcilable with his theory. It is, however, the theory that is clearly erroneous, because it is based on an inapplicable analogy, and not the facts.

II.

The second fallacy with petitioner's analogy is that it leaves out of account the fact that the transfer of respondents' stock and notes to the Institute in exchange for the Institute's $1,300,000 note was a realizing transaction, and therefore a sale or exchange, rather than petitioner's theoretical model of the mere reten-

tion of an income interest with the transfer of a remainder. This Court has repeatedly held, and the statute clearly provides, that the conversion of one property interest into another substantially different interest constitutes a realizing sale or exchange, on which, in the absence of any applicable non-recognition provision, gain or loss must be reckoned. Because such recognized gains constitute the sum of previously unrealized annual increments of value in the capital asset so disposed of, these gains fit precisely within the category of gains for which long-term capital gain treatment was primarily designed. The sale here was such a conversion, for the sellers irrevocably disposed of their stock, the corporation was liquidated, and sellers received in exchange only a note of the buyer secured by the corporate assets, which was eventually paid (to the extent of $936,131.85) in cash installments.

Once petitioner's argument is stripped of the overtones of pure tax motivation and economic unreality which are the products solely of his theoretically-oriented reliance upon an inapplicable analogy, rather than the actual facts of the case, his only remaining contention is that a "sale" within the common understanding of the term is *not* a sale for purposes of Code Section 1222 if full payment of the purchase price is inadequately secured, or is otherwise dependent upon the subsequent productivity of the asset transferred. This contention, however, flies in the face of the well-settled doctrine of realization, one of the very cornerstones of the tax law, which has always required simply a genuine conversion of one asset into another significantly different one (*e.g.* the exchange of shares in a New Jersey corporation for shares in a Delaware cor-

poration representing the same business), and never the termination of the business risks associated with the first asset. On numerous occasions, this Court and lower Courts, the Congress and the Commissioner himself have acknowledged as sales and other exchanges transactions involving precisely these elements of continuation of risk and dependency upon earnings. In fact, as late as this year, although the Treasury had in 1963 requested Congress to enact legislation taxing earnings-dependent sales proceeds as ordinary income, Congress refused and instead, in Internal Revenue Code §483(d) adopted the more limited approach of taxing as ordinary income only an imputed interest element upon this type of sales. The Treasury, which, when addressing Congress, conceded that capital gain treatment can apply to such sales under present law, now in effect asks this Court for the legislation Congress denied.

In seeking to exclude high-risk or productivity-dependent transactions from the category of sales, the Commissioner is not only flaunting the expressed will of Congress, but is also defying the well-settled principle that whenever possible terms in the tax law such as "sale or exchange" should be given their ordinary meaning. Ample authority demonstrates that high-risk or productivity-dependent cash transactions are not in common understanding excluded from the category of "sales."

Because the actual case, unlike petitioner's hypothetical, is no different, from the sellers' viewpoint, from a host of other clearly realizing transactions in other areas, adoption here of the revolutionary principles advocated by petitioner would cast widespread confusion

and doubt upon large numbers of bona fide commercial transactions. For example, it would remove from the category of "sales" uncounted thousands of real estate transactions in the Southern California area alone. The Code neither contemplates nor provides for a category of bona fide complete dispositions of capital assets for cash which are not sales. The creation at petitioner's behest of any such category would be to plunge into an uncharted and thorny thicket of unanswered questions, to create unnecessary and burdensome new areas of artificial definitions in the already complex tax law, and to impose an arbitrary judicial solution upon what is basically a complex legislative problem.

The only authority cited by the petitioner for his bold and sweeping request is a line of cases in the oil and gas field. It is doubtful whether such authorities, arising in an area of the tax law which is shaped by the depletion allowance and other unique factors, should be applied in other areas. Be that as it may, if the oil and gas principles *are* applied to this situation, the result is no different, since this Court's decisions in that field make it clear that both (a) the sale of an oil corporation's stock followed by a corporate liquidation and payment through an oil royalty interest, and (b) a sale of oil and gas property in which the oil royalty is supplemented by a lien on the fee title to transferred lands are *sales* and not reserved income interests. These decisions in oil and gas cases on facts analogous to those of the present case leave no room for petitioner's reliance on this line of cases.

Petitioner calls this "a tax case of rare importance" (Pet. p. 7). Its importance lies, however, not in the opinion below, which merely reflects the unanimous con-

sensus of this Court and all lower Courts that the concept of "sales" is not as sharply limited as petitioner appears to desire, but in the hitherto unheard-of limitations petitioner first sought unsuccessfully from Congress, and now seeks from this Court. Because the case does not on the actual facts involve the economically unreal, tax-motivated type of transaction which petitioner stated that it did in requesting certiorari, because there is no conflict in the lower Courts and the applicable principles of law are there clearly understood, and because the Court of Appeals reached a correct result which gave respondents no tax benefits to which they would not be entitled on any installment sale, this Court should now resist petitioner's demand for gratuitous and far-reaching judicial legislation, and should dismiss this case because of the improvident granting of the writ of certiorari. Failing this, the opinion of the Court below should be affirmed.

ARGUMENT.

INTRODUCTORY.

Petitioner's brief is almost completely devoted to discussion of a set of facts not in issue. It first sets up as a "straw man" a hypothetical stockholder who purports to "sell" his stock for a right to receive all dividends up to a stated amount (Br. p. 16).[2] Throughout the rest of the brief petitioner mercilessly belabors this straw man, but nowhere can or does he demonstrate the straw man represents the actual case. One of petitioner's learned counsel once aptly quoted:

> "Beware the metaphor! Of all the anodynes for the pains of thought, it is the most seductive, the most misleading." Brown *The Growing "Common Law" of Taxation,* 34 So. Cal. L. Rev. 235, 244 (1961).

The same could with equal propriety be said for the extended analogy on which petitioner so completely relies.

The factual differences between petitioner's straw man and the facts of the actual case are not matters of detail and are not mere speculations or inferences. They are clearly set forth in the record of the case and, as we will show, are crucial and determinative of the correct result. To put these differences in a nutshell, the straw man's actions make no economic sense, would only occur for tax purposes and would necessarily involve a grossly excessive "purchase price" (any negotiations over which would be pure sham). Because the

[2]References herein to Petitioner's Opening Brief will be cited "Br. p. 16"; references to the Record will be cited "R. p. 64"; and references to the Petition for Certiorari will be cited "Pet. p. 10."

"purchase price" would grossly exceed fair value for the stock, the predominant nature of the straw man's "sale" would be simply the retention of the "seller's" dividends on his stock for an extended term. A remainder interest would be gratuitously transferred to the "buyer" in the perhaps illusory hopes of obtaining more favored tax treatment on the retained dividends. Moreover, no corporate liquidation would be part of the transaction, so there would be doubt whether the transaction would involve realization of any gain on the stock itself, or (as petitioner contends) would be the mere retention of an income interest. Were such a maneuver successful in producing capital gain, it might indeed involve the "extraordinary tax benefits" which petitioner claims (Br. p. 26) to find in the present case. However, this is *not* the case before the Court, and it is not necessary for the Court to decide what the tax consequences of such a transaction would be.

The record of the actual case, on the other hand, shows conclusively that the transaction made good economic sense to the sellers without reference to their income taxes and without an unreasonably high price, and that the parties, at arm's length, negotiated a purchase price based on actual value and within a reasonable range in the light of the corporation's assets and earnings history [R. pp. 32, 57, 64]. Furthermore, the liquidation of the corporation—an exchange which would *alone* trigger realization and recognition of capital gain on respondents' stock—was part and parcel

of the actual transaction. Accordingly, as we will show, the gain on the actual transaction was simply a realization in cash installments of the hitherto unrealized increments in value of the stock sold—precisely the type of transaction for which long-term capital gain treatment is primarily intended. No "extraordinary tax benefits" are involved, for (at least as long as the price *is* within a reasonable range) the taxpayer is getting nothing he would not be entitled to in any other installment sale. In fact to tax such gain at ordinary rates would be an outright windfall to the government.

In this brief we will first explain why the petitioner's straw man does not represent the actual case and why the differences between them are determinative. Secondly, having disposed of the smokescreen thrown up by the petitioner's assumed "simplified version" of the facts (Br. p. 30), we will explain why the lower courts were clearly correct in holding that the actual transaction constituted a "sale or exchange" for purposes of Section 1222(3) of the Internal Revenue Code of 1954.

I.

PETITIONER'S UNSUPPORTED ASSUMPTION THAT THIS CASE PRESENTS THE SAME ISSUES AS A MERE TRANSFER OF STOCK FOR A PURCHASE PRICE PAYABLE ONLY FROM SUBSEQUENT DIVIDENDS, AND SECURED ONLY BY THE STOCK TRANSFERRED, BEGS THE QUESTION IN THE CASE.

A. The Essential Differences Between Petitioner's Assumed Case and the Actual Facts Are the Actual Transferee's Ability to Double the Earnings of the Business Assets in Its Own Hands, Its Commitment to Pay the Full Purchase Price in a Substantially Shorter Period Than the Corporation Would Have Been Able to Earn a Similar Amount, and the Corporate Liquidation as an Essential Part of the Transaction.

Petitioner's "straw man" may be illustrated by assuming that S owns 100% of the stock of X corporation, which has annual after-tax earnings of $100,000 and a fair market value of $1,000,000 (ten times earnings). If a would-be buyer offers to buy the stock for a "purchase price" payable solely out of the dividends, in annual installments for a given period, the offer would make no economic sense and would not be considered except for tax reasons. It would not reduce S's risks on the downside. He would receive the "purchase price" no faster than an equivalent amount would come in the form of dividends without the "sale," and tax savings aside, he could only end up a poorer man, at any price. Even if the hoped-for tax savings were guaranteed, the "purchase price" would have to be so grossly excessive that the tax savings on the payments made *after* payment of full value would compensate

for the purely gratuitous sacrifice of the remainder interest.[3] Because of its lack of economic justification such a transaction might fall within the ambit of *Knetsch v. Commissioner,* 364 U. S. 361 (1960). The Court does not have to decide this, however, since such facts are not before it.

Suppose, however, that B, a solvent and reputable would-be purchaser, makes a proposition which with minor variations is essentially similar to the transaction in the actual case:

> "I will buy your stock for $1,000,000 and liquidate your corporation. With the assets in *my* hands, I plan to double the annual earnings of the business — whatever they otherwise would have been in the corporation's hands. Accordingly, I will pay the $1,000,000 in annual installments equal to the greater of (a) $100,000 or (b) double the amount X corporation would have earned had it retained the business and assets, full payment to be made within not less than ten years. I will pay double these earnings whether or not I am correct in believing that earnings will be doubled in my hands. Beyond this I will assume no personal responsibility, but the assets of the business will constitute security for payment of both the minimum annual installments and the full $1,000,000."

From the seller's viewpoint, this is a very different proposition. S is offered a substantial and meaningful *economic quid pro quo* for the seller's cutoff of all

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[3]Even then, as petitioner concedes, the transaction would be unrealistic with a taxable buyer because the adverse tax consequences to the buyer would prevent such an arrangement. See *Vermont Transit Co. v. Commissioner,* 218 F. 2d 468 (2d Cir.), *cert. denied,* 349 U. S. 945 (1955).

rights on the "upside." By virtue of the guarantee of doubled earnings, he receives a reasonable "cushion" of assurance that full payment of the purchase price will be made within the stated period, and has the absolute assurance on the downside that even if economic disaster strikes the business and the buyer fails to complete payment within the prescribed period, the seller will at least be substantially better off than if no such transaction had been entered into. These facts are true *without regard* to the income taxes that the seller will be required to pay.[4]

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[4]The difference between the tax rates applicable to ordinary income and to long-term capital gains will (*ceteris paribus*) cause a holder of appreciated stock of a closely-held corporation to prefer the realization of his gain through a final disposition such as sale of his stock or liquidation of the corporation, to the distribution of dividends taxable at ordinary rates. Although in economic fact the realized gains on a final disposition primarily represent the sum of past undistributed corporate earnings and the discounted expectancy of future profits, the tax law creates a strong bias in favor of realizing on such past earnings and future expectancy through a sale or liquidation rather than through retention of the stock and receipt of dividends. Any experienced tax practitioner can testify that sales of stock and liquidations are common, but the declaration of a dividend by a closely-held corporation (other than a "tax option" corporation) is a rarity. This bias toward the sale or exchange was preferred by Congress to the locked-in effect which would have been caused by taxing gains on such transactions at ordinary income rates. See *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 265 (1958). Thus many if not most sales of stock, including presumably the ones before the Court, are "tax-motivated" in that they would not have occurred had the gains been taxable at ordinary rates. This does not, however, solve the question before the Court—which boils down to whether the price was set within a reasonable range by arm's length negotiations (as found by the Tax Court) so that the gains in question predominantly constituted the realization of past accrued values, or whether (as claimed by petitioner in the teeth of these findings) the price was not set by good-faith bargaining and substantially exceeded fair value, so that to the extent of such excess there was arguably the retention of an interest in future earnings.

The economic consequences of our hypothetical transaction are quite different from the "straw man." If the business continues at the same level, B will pay $200,000 per year. S will have his $1,000,000 in five years and walk away without subsequent worries about the fortunes of the business. He will have received this sum five years earlier than he could have received such a sum from earnings, had he not sold his stock. If profits *improve,* S will get *no more* than his $1,000,000, but payment will be completed faster. Even if both profits and the value of the business assets decline substantially, S is still reasonably secure, since the doubled earnings provide a good cushion. If there is an immediate drop of, *e.g.,* 50%, in profits, S will *still* receive his full $1,000,000, even without recourse to his security. In such event, it will take the full 10 years provided in the agreement—but if S had not entered into the transaction, he would only have received $500,000 of earnings during the same period, so he is well ahead economically. Even if both profits and asset value decline immediately by as much as 60%, so that the business would have earned only $40,000 annually in S's hands, and B's actual annual personal liability will only be $80,000, B must either pay $20,000 more per year (or $200,000 over the 10 years) or face foreclosure by failing to meet the required $100,000 minimum annual payments. If the business is still worth $400,000, a rational buyer will come up with the $200,000 to save it. Each year in which payments are received increases S's cushion and puts him in an even more secure position.

Since S can predict results for the immediate future with more assurance than later events, a substantial

measure of added security is provided by the early payments. S's substantial and growing cushion leaves the assets as security for only a fraction of the purchase price—exactly the situation in which the petitioner has said there would be a sale (Br. p. 19).

A complete economic disaster occurring to the business, particularly in the early years of the payout, may prevent S's receipt of the full purchase price, just as it could with a down payment. However, even in such unusually adverse circumstances, S will at least be substantially better off economically (without reference to his taxes) than he would be if he had not sold the stock. For instance, if after 3 years profits unexpectedly stop *completely* and the value of the assets declines 70% (from $1,000,000 to $300,000) S will at least have received a total of $900,000 of his agreed purchase price—$600,000 in annual installments and $300,000 on foreclosure and sale of the assets. Taxes aside, he will be $300,000 richer than he would be had he not sold and had the same disaster occurred. The sale will have the effect of shielding him from most of the downside loss he would have incurred by retaining the stock.

To put this in other words, even if petitioner's theoretical analysis demands a cushion of added *assets* (*e.g.*, a large down payment or substantial personal liability), in the market place a cushion of added *earning power* provides equally satisfactory assurances of final payment. The market place measures an income-producing asset principally in the light of the income it produces, and if it can be made to produce double the income, it is worth twice as much in terms of security. The buyer who will guarantee this has

quite as much to bargain with as the buyer who puts up a down payment. The proof of this proposition is the actual facts of this case, in which the price was within a reasonable range in the light of earnings and net worth [R. p. 64]. No doubt a down payment *added* to this cushion even further reduces the elements of futurity and risk. However, the effect of a down payment on the sellers' thinking was scarcely as earth shaking as petitioner believes, since the sellers themselves initially offered a price reduction of only 11.2% for a cash down payment.[5] From the practical standpoint with which risk is weighed in the market place, B's accelerated payment proposal may indeed be preferable to a mere down payment with slower installments, since the "cushion" afforded by B's transaction continually swells and reaches its maximum during the latter part of the payout period when the crystal ball will be cloudier and risk of disaster greater, while the cushion of a down payment remains constant. However, we are here comparing only relative degrees of risk in different economically viable transactions—an entirely different matter from the economically nonsensical proposition of petitioner's straw man, in which all possibility of gain on the upside would be sacrificed with no concomitant acceleration or downside cushion whatsoever.

Petitioner relies upon the proposition that where a buyer contributes nothing, normal bargaining over value will not exist, and an unreasonably high price will necessarily emerge. He concedes that a buyer's pledge to contribute added income through his *services* may

[5]Sellers' initial offer was $1,440,000 without a down payment or $1,280,000 with a down payment [R. p. 27].

permit characterization of a transaction as a sale (Br. p. 62). In his brief, he nowhere explains why a transferee's guaranteed contribution of added income arising from the transferee's expectation of tax exemption (but nonetheless guaranteed) does not have the same economic result.[5a]

The key factor which distinguishes the case which petitioner is arguing from the actual case is that the Institute's expectancy of a substantial increase in the earnings of the assets taken through liquidation directly into its hands permitted it to contract to pay full fair value for the stock from the thus enhanced earnings in a far shorter period of time than the same amount would have come to respondents in the form of dividends from corporate earnings, or even in the form of, *e.g.*, a 30% down payment followed by delivery of all subsequent dividends received until payment in full. Here we have an *exchange* of asset values for cash, and for cash in substantially greater amounts than would have come through earnings during the payout period; not the straw man's gratuitous *sacrifice* of asset values without receipt of such extra cash. The difference is vital, because where there *is* a substantial *quid pro quo* and reasonable assurance of payment there will be a bargaining situation resulting in a price within a reasonable range of fair value; in the straw man case where a "buyer" supplies no *quid pro quo*, he has nothing to bargain about, the rules of the market place will be inapplicable, and any resulting purported sale would merely be a gratuitous transfer of a remainder

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[5a] In his Petition (p. 24 n. 30), he appears to admit this, although he argues that the resultant bargaining had a different content from commercial bargaining—a contention belied by the Tax Court's findings [R. p. 32].

interest in stock in hopes of reducing the taxes on subsequent retained earnings. In *assuming* that there will be no liquidation and that payment will simply be out of dividends (Br. p. 29), petitioner assumes away the very economic *raison d'être* of the actual transaction and completely begs the question.[6]

A seller will in practice, of course, demand something more for any installment sale than presently-realizable *cash* value, in order to compensate him for the elements of futurity of payment and residual risk of non-payment. We do not understand petitioner to argue (nor could he rationally) that an installment sale is not a sale for tax purposes until *all* futurity and risk of payment are removed. The only sale so qualifying is a 100% cash purchase. The very existence of Internal Revenue Code Section 453 demonstrates clearly enough that the term "sale" is not so narrowly restricted. Petitioner, however, does contend:

> And a necessary consequence of *the price being greater than the presently-realizable cash value* of the stock is that A will not only bear the full risk of any future losses but will also share in the benefit of any future income production or capital appreciation. What he receives, therefore, will represent not the proceeds from his "cashing in" on the values accrued in the past (*i.e.*, the present value

[6]Moreover, in simply *assuming* (contrary to fact) that the liquidation was not a relevant part of the entire transaction, and "can be ignored" (Br. p. 27), petitioner attempts to sidestep a further crucial difficulty with his argument—the clear existence in the actual case of a *realizing transaction* on which gain must be recognized, rather than the simple *reservation* by a stockholder of an interest in corporate dividends. See pp. 42-60 below.

> of the stock), but the proceeds of his continued risk-bearing participation in the future gains and losses. (Br. p. 37.) (Emphasis added.)

Taken literally, this contention *would* damn all installment sales, for in every such sale a seller will charge *something* more than "presently-realizable cash value," for futurity and risk, whether such excess takes the form of "interest" or merely a higher "time-price." See *M. Pauline Casey,* 38 T. C. 357, 382-83 (1962).[7] We cannot believe, however, that petitioner intended to go so far. He expressly concedes, as he must, that "normal" installment sales are sales, no doubt despite this inevitable increment in price. Nor does petitioner merely contend that long-term capital gain treatment is available to so much of the price as represents "cash" value, while only the increment which represents futurity and risk receives ordinary treatment,[8] since he argues that where the price exceeds a cash price there is no sale at all but only a reserved income interest, and would treat the entire payments as ordinary income. Petitioner's argument, taken literally, proves too much. It can apply, if at all, only to situations like his straw man case where the elements of futurity and risk are so *extreme* that the purchase price will contain an *inordi-*

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[7]When compensation for risk and futurity takes the form of a time-price differential, there may be a question whether such an increment should be treated as "interest" for tax purposes. This question is not present in the case at bench, however, because it was decided adversely to petitioner by the Tax Court [R. pp. 69-71], and because petitioner has not preserved the issue on appeal [R. p. 289]. The point is moot for future transactions because Congress this year enacted Section 483 of the Internal Revenue Code, which automatically provides an imputed interest element on deferred payment sales the terms of which do not provide for sufficient interest payments.

[8]In any event, such an argument is here foreclosed. See note 7.

nate element of compensation for futurity and risk, and will therefore *not* be within a reasonable range in the light of the asset values and earnings history of the business. Here, however, petitioner runs into the inescapable differences between his straw man case and the actual facts. Whether or not the type of "cushion" which the Institute guaranteed meets petitioner's theoretical formulation of what a cushion should be, the stubbornly inescapable central fact is that in the market place that cushion was sufficiently significant to produce a negotiated price within a reasonable range in terms of true value, and not the grossly inflated price imagined by petitioner in the case of his straw man [R. p. 64]. As a matter of hard practical fact and not of mere theoretical analysis, the futurity and risk elements of the transaction in question fit comfortably within the generality of installment sales and bear no resemblance to the extreme facts upon which petitioner relies.[9]

From the respondents' viewpoint, the substance of the actual transaction in this case was the same as in the above somewhat simplified example. As long as re-

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[9]Even if (untrue in the present case) the risk of nonpayment and the element of futurity had been so great, and the compensation for these elements so substantial, that the total purchase price *exceeded* a reasonable range, this would not (at least short of petitioner's imagined economically meaningless transaction) mean that no *sale* had occurred. In the straw man case, the element of futurity becomes so great that the "sales price" will be paid only at the same rate as the income the "seller" would otherwise have earned, and the element of risk becomes infinite, because there is no cushioning whatsoever of the seller's downside risks to compensate for the sacrifice of possible appreciation on the upside. Therefore, there is no *economic* justification for less than an *infinite* amount of compensation for risk and futurity, and the transaction would occur at all only for tax purposes. Of course, this Court need not

spondents retained their stock, over one-half of the corporate earnings would go to pay federal and state corporate income taxes. The Institute offered to buy the stock, liquidate the corporation, continue the business with ownership of the assets in the Institute's hands, and make annual payments to respondents on the purchase price at the rate of 90% of its rental receipts, or 72% of earnings *before taxes and depreciation,* which payments would be very substantially in excess of the earnings the corporation could have enjoyed had there been no sale.[10] Apparently as a precondition to the sellers' agreement to sell [R. p. 273], the Institute expressly agreed to pay these amounts in all events, and did *not* condition its agreement on the absence of taxation to it [R. pp. 200, 203]. Respondents, of course, had no reason to care, as long as the Institute guaranteed these payments, whether the Institute would, as it expected, remain tax-exempt and meet this guarantee without out-of-pocket expense, or whether it would later be taxed on the same receipts at 52% plus state taxes,[11] and therefore bear a substantial out-of-pocket

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decide what the tax results of such an extreme transaction would be, since no such transaction is before it. Whatever may be the appropriate tax treatment for those portions of the purchase price representing risk and futurity, a portion of the payments in any genuine negotiated final disposition for cash installments will be simply the underlying cash sales value of the property, which if stated separately from the compensation for risk and futurity is clearly entitled to long-term capital gain treatment. To argue that there is no sale without such a separate statement is absurd, since mere labelling cannot make the difference between a "sale" and a "reserved income interest."

[10]Depreciation deducted for the year ended April 30, 1952 was $49,722.99 [R. pp. 161, 166]. Hence the exclusion of depreciation as well as taxes in computing earnings was a material benefit to respondents.

[11]In California, taxable corporations must pay a franchise tax, which during the years in issue was at the rate of 4% of income, and is now 5.5%. Cal. Rev. & Tax. Code § 23151.

burden. In either case, the *guarantee* of accelerated payments to the respondents provided substantial bargaining power to the Institute, as the realistic price confirms.

We believe the Institute is correct in its belief that Congress did not intend to subject it to tax on rentals received under a five-year lease. However, this will be resolved at another day and in another court.[12] Suffice it to say that the petitioner can scarcely be serious in claiming (Br. p. 58) that the Institute assumed no risk of out-of-pocket expense in making its guarantee, since petitioner officially holds that such receipts are taxable to charities, Rev. Rul. 54-420, 1954-2 C.B. 128, and since petitioner has revoked the Institute's exemption and seeks in a pending Tax Court case to tax it on the very same amounts which in this proceeding he would also tax to respondents [R. pp. 141-142]; *West Los Angeles Institute for Cancer Research v. Commissioner,* Tax Court Docket No. 94372.

It is also clear that if the Institute *were* to pay an exorbitant purchase price for the stock it would be vulnerable to loss of its exemption on the grounds of causing an inurement of earnings to private individuals. Section 501(c)(3). In the one case of this type in which an exorbitant price *was* paid, in fact, the feeder corporation was held not to be exempt for this very reason. *Emanuel N. (Manny) Kolkey,* 27 T. C. 37 (1956), *aff'd on other issues,* 254 F. 2d 51 (7th

[12]The legislative history of the 1950 "Supplement U" amendments to the 1939 Code demonstrates complete legislative familiarity with the present problem. See H. R. Rep. No. 2319, 81st Cong. 2d Sess. 36-40 (1950). The legislative decision, in effect, permitted sales to charities financed through leases not in excess of 5 years.

Cir. 1958). Consequently, to the normal assurances of reasonableness of price provided by arm's length negotiation in a true bargaining situation can be added the further guarantee that the charity's own tax position would not permit an unreasonably high price.

Further guarantees of a price within a reasonable range are found in the practical effect of the five-year business lease provisions of Sections 512(b)(3) and 514(b)(1). All negotiations were conducted on the basis that the Institute must anticipate complete payment at least within the five-year term of the original lease [R. pp. 29, 32-33, 35, 36, 138-139, 272]. This, as a fully informed Congress presumably intended when these provisions were enacted in 1950, set a practical limit on the purchase price of about 3.6 times anticipated annual before-tax earnings[13] (about 7.2 times after-tax earnings), scarcely so exorbitant as to negate a sale. Finally, even the sellers would not have been anxious to seek a price unrealistically out of line in the light of the true earnings capacity of the business, because of the drastically unfavorable tax consequences of foreclosure. In the event an inflated price was established, if it had become necessary to take back the property, all hitherto unrecognized gain would be immediately recognized up to the fair value of the property upon repossession by the seller, and the sellers would be left "high and dry" with a large immediate tax bill and no money to pay it.[14]

Certain restrictions and obligations of the Institute as a charitable institution shaped and determined the detailed form which the transaction took, but did not

[13] 72% x 5 = 3.6. See note 12.

[14] Section 453(d).

change its basic nature as a sale. Direct operation of a business was neither an appropriate undertaking for a bona fide charity nor was it permitted without adverse tax consequences under Section 514. Consequently, an operating company (Fortuna) was formed with the investment of independent capital, and the business assets were rented to Fortuna. The Institute charged rent to Fortuna for the assets in an amount equal to 80% of the company's profits before taxes and before depreciation; thereby receiving its return on the investment in the permitted and appropriate form of passive rental income. Mr. Brown held no equity in Fortuna and did not share in its profits and as manager until 1954 received only a salary for his services as an employee [R. pp. 44, 48]. The Institute made no down payment for the business except out of the acquired assets since it could well be construed to be improper for a charitable organization to accumulate funds out of tax-free income for the purpose of subsequently buying businesses. Section 504(a)(1). The Institute insisted upon retaining 10 per cent of its rental receipts during the payout period, since it is prudent for a charitable institution to require some current return, even during a buyer's payout period.[15] These facts reduced the buyer's guaranteed payments to the sellers to amounts equal to 72% of the earnings before taxes and depreciation, but this amount still far exceeds the less than 48% of earnings before state and federal taxes available but for the sale. Like any buyer of income-producing assets, the Institute hoped and expected to recoup the purchase price from subsequent earnings. Due

[15]See the argument made by the government in *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899, 902 (Ct. Cl. 1956).

to its tax exemption, however, the Institute's earning power was so much greater than that of respondents' corporation that it could, without anticipating out-of-pocket expense, make payments which would cause a normal buyer to dig deeply into its own pocket. As long as the seller gets a fair price and reasonable payments, however, he is unconcerned over where the buyer gets the money, and there is no reason for this to affect the seller's tax consequences.

B. The Facts Not Only of This Case But of the Numerous Other Similar Cases Show That the Economically Sound Transaction, Not Involving a Grossly-Excessive Purchase Price and Not Conforming to Petitioner's Model, Is the Normal Situation.

1. The Facts of This Case Show, and the Tax Court, Held, That the Purchase Price Was Negotiated at Arm's Length on the Basis of Actual Values, and Was Within a Reasonable Range in the Light of Corporate Earnings and Net Worth.

On the view petitioner takes of the case, true installment sales can be readily distinguished from the economically unreal transactions to which he would not accord capital gain treatment by the degree to which the buyer furnishes a real *quid pro quo* for the seller's relinquishment of upside possibilities, and can therefore bargain for a fair price. He further contends that a grossly-excessive purchase price is both the infallible touchstone by which the unreal, purely tax-motivated transaction can be spotted (Br. pp. 20, 37), and the principal reason for denial of capital gain treatment thereto (since, in his view, to allow such treatment of sums paid *after* receipt of a reasonable price is so to

tax mere dividends, for which such favorable treatment was never intended) (Br. pp. 37, 59-60). Thus in petitioner's view, the entire case hangs on the reasonableness of the purchase price.

All this is interesting as a matter of theory. However, eventually petitioner has to get down to the *facts of this case,* and it is at this crucial juncture that the essential weakness of his theoretically-oriented argument becomes most glaringly apparent. *For the facts of the case simply do not fit petitioner's theoretical model.*

Petitioner "assumes" there was no liquidation (Br. pp. 16-17, 27-29)—but there *was.* Petitioner "presumes" the purchase price substantially exceeded fair value—and "shows" that the bargaining must have been economically meaningless (Br. pp. 20, 36)—but the trier of fact held to the contrary [R. pp. 32, 64].

Petitioner's theories are a Procrustean bed to which the awkward facts of this case bearing on the crucial and sensitive question of value do not readily conform. We regret to be forced to say that at certain points in petitioner's brief, it appears that, like Procrustes, he has stretched a fact here and chopped off one or two there, at points where such treatment would help the facts better fit his preconceptions.

We refer to the following:

(1) At page 18 of petitioner's brief appears this sentence:

> Since no reasonable man moved only by economic considerations independent of taxes would agree to such a transaction with a stranger however great the stated amount of dividends to be remitted

might be, and since the stated amount must be substantially greater than the present value of the stock for the transaction to yield even a tax advantage, it must be presumed that the amount agreed upon in such a transaction between strangers is in fact—*as the courts below acknowledged it probably was here—substantially greater* than the value of the stock at the time of the transaction (Emphasis added).

We find nothing, and petitioner cites nothing, in the opinion of either of the "courts below" which supports the key words "substantially greater," and nothing at least in the Tax Court's opinion (the trier of fact) which justifies the word "probably." The Tax Court *did* state that the price "was the result of real negotiating," and "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets" [R. p. 64]. It *did* say, accepting the Government's contention for the sake of argument, that "It *may* be, as respondent contends, that petitioner would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization," [R. p. 62] (Emphasis added). It also said that (on the same assumption) a sale is not to be ignored for tax purposes because of a *"somewhat higher* price than someone else might pay" [R. p. 62] (Emphasis added). There is a difference, we submit, between "somewhat higher"—which would be true of any installment sale—and *"substantially higher."*

(2) Corporate net worth is an important criterion in fixing value. On this, petitioner says only:

> At the close of its fiscal year ending April 30, 1952, the Corporation's net worth was $397,782.10 [Ex. 21-U, R. 167] (Br. p. 4).

In all fairness he might not have "chopped off" the following further facts:

(a) The quoted figure represented not "net worth" but *book* net worth. There can be (and was here) a big difference.

(b) In order to compare even "book" net worth with the $1,300,000 purchase price, $125,000 must be added for stockholder notes included in that figure—making $522,782.10 as of April 30, 1952 [R. p. 37].

(c) By the date of the sale, book net worth (including the said notes) had grown to $619,457.63 [R. p. 22]. Thus book net worth *alone—i.e., actual cash shareholder investments and tax-paid corporate earned surplus*—accounted for almost half of the full sale price, without any allowance for the substantial appraised appreciation in value of corporate assets or for the expectancy of future earnings, let alone for a reasonable time-price differential.

(d) Most important of all, the Institute entered into the transaction in reliance upon the company's *appraised* net worth which (with apparently unchallenged post-appraisal adjustments) came to $1,064,877 [R. p. 32]. This figure alone (without allowing anything for the high corporate earnings expectancy) represented 82% of the agreed $1,300,000 purchase price of the stock and notes combined. The remaining 18% is well within a normal range of time-price differential [R. pp. 32-33]. This net worth figure was based on an appraisal made two or three years before the sale, and updated for subsequently acquired assets [R. pp. 135-

Institute as simply a mendicant, hat in hand, readily replaceable and ready to pay without argument the highest price the sellers felt they could get away with (Br. pp. 33-34). In fact, the Institute only selected 2 of some two dozen deals it looked at [R. pp. 36, 138].

Even the unexpected post-sale impact of adverse economic events, far from indicating an economically meaningless transaction, highlights the substantial downside protection given respondents by their sale. In the teeth of the unforeseen economic disaster which entirely choked off the previously high profits of the business and reduced the net asset values to a mere 23% of their original worth,[16] the sellers received $936,131.85, or 72% of the agreed purchase price. Had the sellers *retained* their stock instead of selling it, and had the same reverses occurred, they would have been poorer by at least $250,000,[17] without reference to their personal income taxes. They ended up, therefore, in no worse position than they would have been in with a $250,000 down payment and subsequent installments of all after-tax earnings. Had the economic decline been less extreme, full payment would still have easily been made.

In view of the petitioner's convincing proof (Br. p. 36) that a substantially excessive price necessarily marks the non-negotiated, economically unreal trans-

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[16]From $1,300,000 to $300,000 [R. p. 55].

[17]Fortuna net profits from February 4, 1953 to October 31, 1957 were about $805,000 *before depreciation* [R. p. 56]. Had these profits been earned by the old corporation, profits after taxes and depreciation would have been less than $400,000. Instead, respondents received over $650,000 in installment payments during the same period, illustrating the substantial "cushion" given them by their sale [R. p. 56].

action of the type to which he would equate the sale of respondents' stock, the well-supported determinations by the trier of fact that the actual sale price was negotiated at arm's length in terms of actual values, and was within a reasonable range in those terms [R. pp. 32, 57, 64, 66-67.]—if accepted by petitioner—are demonstration enough that the sale was no such transaction. Since petitioner's conception of the sale cannot possibly be reconciled with the Tax Court's factual determinations, however, we can only conclude that petitioner's brief is really an attack on these findings (*Cf.* Br. pp. 56-57). But these findings must stand unless clearly erroneous.[18] If it *is* petitioner's position that the findings are clearly erroneous, then their solid factual support in the record seems to have caused him to choose a most unusual and circuitous mode of attack. *Ignoring* the actual evidence, he has adopted a purely theoretical approach, in which he "proves" by assuming a "simplified version of the transaction" that the sale was without economic meaning. Like the learned professor who "proved" by aeronautical theory that the bumble-bee cannot fly, petitioner should look up from his theorizing long enough to face the facts.[18a]

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[18] *Commissioner v. Duberstein*, 363 U. S. 278 (1960); *Rudolph v. United States*, 370 U. S. 269 (1962); *United States v. Yellow Cab Co.*, 338 U. S. 338 (1949); *Timken Roller Bearing Co. v. United States*, 341 U. S. 593 (1951); *Austin v. Commissioner*, 298 F. 2d 583 (2d Cir. 1962); *Commissioner v. Goodwyn Crockery Co.*, 315 F. 2d 110 (6th Cir. 1963); Fed. R. Civ. P. 52(a); Int. Rev. Code § 7482(a).

[18a] The Government mythology of an inevitably exorbitant price for these transactions may be traceable to an article by Geoffrey J. Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business*, 108 U. of Pa. L. Rev. 623 (1960). Mr. Lanning was one of the Commissioner's counsel before the Tax Court in the *Kolkey* case, and was no doubt repelled by the highly

2. The Other Cases on Similar Facts Also Demonstrate the Unrealistic Nature of the Assumptions Upon Which Petitioner Relies, Since Despite the Presumption of Correctness Enjoyed by the Commissioner's Contrary Determinations, the Triers of Fact Have Rarely Found Grossly Excessive Purchase Prices.

Petitioner's theoretical arguments based on his erroneous analogy can be refuted not only by the facts of the present case, but by similar factual determinations in numerous other cases involving similar transactions. If petitioner were correct in his views, one would anticipate that the reports would be full of instances of sham negotiations and grossly excessive purchase prices—particularly since the Commissioner enjoys the litigating advantage of a presumption that his determinations are correct. Despite petitioner's theories, he has cited (and we know) only one instance where a seller *was* held to have "sold" for a grossly excessive and unrealistic price, and in that one case both the Tax Court and the Court of Appeals denied long-term capital gain treatment to the purported seller. *Kolkey v. Commissioner,* 254 F. 2d 51 (7th Cir. 1958). In most of the cases, in fact, the price was expressly found to be within a reasonable range, or not grossly excessive. The facts of these cases stand in glaring contrast with the conclusion demanded by petitioner's theorizing.

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sordid facts of that case. This may explain his firm moral conviction and that of petitioner here (in the face of all the facts) that other sales to charities are all only *Kolkeys* in more artful disguise. See, *e.g.*, Br. p. 25, Pet. pp. 20, 33. Thus Lanning seems to attribute all factual findings which run counter to his mythology either to the mistakes of Government counsel or the error of the lower courts. Lanning, *supra*, at pp. 642, 646. Since he wrote, there have been a number of similar cases involving realistic prices, including this one, but the Government by now appears too firmly wedded to its myth to be shaken by any number of mere facts.

In *Ohio Furnace Co.*, 25 T. C. 179 (1955) (Reviewed), a case in which the tax exemption of the purchasing Foundation was challenged but the tax treatment of the seller was not in issue, the Court stated that

> "the price paid for the stock in our opinion appears to have been reasonable, and the respondent does not contend otherwise. . . . Inasmuch as the investment in the Furnace Company stock was a sound investment and the price was fair, the payments from the Foundation's income to the sellers of the Furnace Company stock did not constitute an inurement of the Foundation's income to them but was (sic) the consideration in a purchase of stock for value received." (25 T. C. at 189.)

In *Knapp Bros. Shoe Mfg. Corp. v. United States*, 142 F. Supp. 899 (Ct. Cl. 1956), the price was $5,100,000 payable out of earnings, or about 5½ times the company's 1947 after-tax profits of $908,792. The Court held the purchasing "feeder corporation" exempt. Not only was the price fair and reasonable, but ". . . the purchase was a great bargain." 142 F. Supp. at 902. Within three and one-half years, the feeder, which was capitalized at $1,000, had paid out of income the entire purchase price with interest, including a down payment which it borrowed from a bank, and had even paid the Federal taxes erroneously assessed against it by the Commissioner.

In *Estate of Ernest G. Howes*, 30 T. C. 909 (1958), *aff'd sub nom. Commissioner v. Johnson*, 267 F. 2d 382 (1st Cir. 1959), the Tax Court, holding the seller to be entitled to capital gain treatment, and the purchasing feeder corporation exempt, stated:

> Suffice it to say, after a careful consideration of record, . . . we are satisfied that the total contract price . . . was fair and just, and was arrived at through arm's-length dealings between the parties. (30 T. C. at 923.)

On appeal, the Commissioner relied upon the same grounds here urged—that there was no infusion of new funds and no risk of capital.

The Court of Appeals observed:

> Even though this be so, this factor is of minor significance for often purchases are financed by mortgages taken back by the seller. In such an event a real risk is borne by the mortgagee but this does not cause an otherwise valid sale to become something less than that. (267 F. 2d at 385.)

The interesting thing to note is that a fair price *was in fact* negotiated, despite this continuation of economic risk—demonstrating once more that the cushion provided by the exempt purchaser's added earning power produces *in practice* the economic equivalent of an independent infusion of risk capital, and makes possible, contrary to petitioner's theory, an arm's length sale at a "fair and just" purchase price.

In *Anderson Dairy, Inc.*, 39 T. C. 1027 (1963), the taxpayers sold their partnership business to University Hill Foundation for $1,000,000 and sold associated real property for $250,000, with a down payment of $15,000 and on terms otherwise quite similar to those in the case at bench. In the same year an independent profit-making corporation, Beatrice Foods, had at arm's length tentatively offered to buy the business at the same price of $1,000,000 (excluding the real property,

which was valued by the seller at $300,000), but other problems made this sale impracticable. 39 T. C. at 1029-30. The Tax Court found as a fact that the *cash* fair market value of the property transferred was $945,000 (or 73% of the agreed installment sales price). 39 T. C. at 1034. Since it was provided that payments were to be made without interest over a ten-year period, it seems clear that, as in the case at bench, most or all of the 27% spread between cash value and the time sales price was well within line as a reasonable time-price differential. The Tax Court held "the final purchase price was the result of real negotiations" and that "the price paid by the Foundation was not grossly excessive." 39 T. C. at 1042.

In *Royal Farms Dairy Co.*, 40 T. C. 172 (1963), the taxpayers in 1953 sold their stock in Royal Farms Dairy Co. ("Royal #1") to University Hill Foundation for a price of $2,680,000, payable $10,000 down and the balance over not more than ten years, without interest, on terms similar to those at bench. Again, the Tax Court rejected the Commissioner's claim on an excessive price, finding:

> "The fair market value on July 31, 1953 of Royal #1 as a going business exceeded $2 million and was not substantially different from the price set in the sales agreement." (40 T. C. at 183.)

and that (as in Clay Brown):

> "Here, the price 'was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.'" (40 T. C. at 185.)

Even the *Commissioner's* witness placed the cash value at 78% of the actual installment sales price (40 T. C.

at 185 n.6). If this valuation be accepted, the 22% spread again represents no more than a reasonable time-price differential.

In *Ralph M. Singer,* P-H T. C. Mem. ¶63,158, 22 CCH T. C. M. 759 (1963), the taxpayer sold stock in three companies to University Hill Foundation, for prices of $1,233,335, with nothing down (Lakeview); $210,000, with 16.7% down (Clark); and $2,997,000, with 7.3% down (Trinity). On the Trinity sale, the only one in which the question of unreasonable price was discussed, the Tax Court carefully considered the asset values and concluded that "the final purchase price was not grossly excessive."

In *Isis Windows, Inc.,* P-H T. C. Mem. ¶63,176, 22 CCH T. C. M. 837 (1963), the taxpayers on June 16, 1952 agreed to sell to University Hill Foundation all the stock of Steel Window Corporation, for $235,000, ($10,000 down) and certain real property for $40,000. The terms were again similar to those in the current case, with non-interest bearing installment payments. Within a mere two and one-half years the entire purchase price had been paid by the Foundation from the earnings of the business. Once again, the Court found the price to be "within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of the corporate assets."

In *Oscar C. Stahl,* P-H T. C. Mem. ¶63,201, 22 CCH T. C. M. 996 (1963), University Hill Foundation agreed to pay a price of $820,000 ($1,000 down) for the taxpayers' stock in American Extruded Products Co. This figure represented about 3¾ or 4 times

the anticipated before-tax earnings of $200,000 to $225,000 for the year of the sale. (Actual earnings for that year proved to be $287,773.11.) Substantially full payment was made within five years. The Court stated that "Under the circumstances we do not think the $820,000 purchase price was so unreasonable as to prove or even indicate that the agreement was other than what it purported to be."

In *Estate of James L. Hawley,* P-H T. C. Mem. ¶61,038, 20 CCH T. C. M. 210 (1961), the taxpayer and others sold their stock in Hugh H. Eby, Inc. for $2,500,000 to an exempt Institute. Judge Raum, who was later to dissent in the present case, made no express findings as to value and noted that it was a close case, but that on all the evidence it was a true sale (not like *Kolkey,* as to which case Judge Raum said "the Court felt that the transaction . . . was a sham.")

In *Estate of Cordie Hawthorne,* P-H T. C. Mem. ¶60,146, 19 CCH T. C. M. 770 (1960), the taxpayers sold their stock to a church for $3,128,617.72, payable in minimum annual installments of 10% of corporate sales. The Court stated that the price "was apparently a fair evaluation of the asset they disposed of." The Commissioner did not argue that the price was grossly excessive, and the court found that the sale price "appeared to be a reasonable amount" "to all parties to the transaction."

In *Union Bank v. United States,* 285 F. 2d 126 (Ct. Cl. 1961), the trial commissioner found $1,174,006.23 to be the fair value of business assets sold to charity for book value plus $2,050,000. Although in this case the purchase price exceeded cash value, the Foundation

made a down payment of $100,000, evidencing its bona fide expectation of completing payment out of earnings and apparently payment was so completed in ten years. The Court of Claims held that despite the relatively high price the transaction was a bona fide sale.

The present case and the above eleven other cases are the only cases known to us involving transactions of the general type here in question in which the Courts found bona fide sales to have occurred.[19] In at least ten of these twelve cases the findings of fact regarding value mock the government's theoretically-oriented contentions.[20] In all twelve of the cases the intent was to sell the stock and the price was arrived at in good faith negotiations centering on true value. The findings of the Court in the present case were therefore typical, and not a mere inexplicable aberration. Since only an irrational seller would sell at a price within a reasonable range if the sale was truly characterized by the inordinate risks and absence of acceleration of payment of petitioner's theoretical model, the existence of

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[19]In *Warren Brekke*, 40 T. C. 789 (1963), the seller was not before the Court, and the issue was limited to deductibility by the operating company of rental payments made to the charity for the former assets of Weiser Company. The Court found that the rental payments were not in excess of a fair rental, but held the sale (and thus the lease) not to have been bona fide, in part because the purchase price was found to be almost double fair value. The taxpayer presented no evidence on the fair value of the stock because in his view of the case the only issue was the reasonableness of the rents. However, it is his position on appeal that the finding on value was clearly erroneous, particularly since full payment was made out of earnings within 3½ years.

[20]Possible exceptions are *Estate of James L. Hawley, supra* and *Union Bank v. United States, supra*. Even there, however, the negotiations were genuine and bona fide sales clearly intended by both parties.

numerous sales of this type at realistic prices proves that in the hardheaded evaluation of the market place, the risks of such a transaction are not in practice deemed inordinate and that these sales are customarily treated like any other installment sales. The results indicate that charities are not in practice as bereft of bargaining power as petitioner would have the Court believe. The facts of other cases, as of this one, preclude the arbitrary denial of long-term capital gain treatment on petitioner's theoretical grounds.

Finally, the lower Courts have amply demonstrated their ability to distinguish the true negotiated sale situation from the "sham" case where a price *is* as grossly in excess of fair value as petitioner seems to feel all non-down payment, non-recourse sales to charity must be. In *Emanuel Kolkey, supra,* where the "purchase" price was over three times fair market value, both the Tax Court and the Seventh Circuit Court of Appeals had no difficulty holding the transaction not to be a genuine sale. *Cf. Evans v. Rothensies,* 114 F. 2d 958 (3d Cir. 1940). Taxpayers are not entitled to a rule of law that automatically sanctifies *every* purported sale to a charity, and *Kolkey* always stands guard against abuses. By the same token, the petitioner has no legitimate right to seek from this Court, as he does, a holding that as a matter of law, a non-recourse, non-down payment sale to a charity will not be recognized for tax purposes—however genuine the negotiations, however reasonable the price, and however clear the intent of the parties. If the petitioner feels such a rule is desirable, his remedy must be with the legislature.

II.

THE TRANSACTION IN QUESTION CONSTITUTED A SALE WITHIN THE MEANING OF CODE SECTION 1222(3).

A. The Gains in Question Fit Precisely Within the Central Core of the Type of Gains From Disposition of a Capital Asset for Which Long-Term Capital Gain Benefits Were Designed.

1. Respondents' Final and Unequivocal Conversion of Capital Assets Into a Substantially Different Form Was a Realizing Transaction.

The above demonstration of the theoretical and factual fallacies in petitioner's approach to the definitional question in this case would not by itself affirmatively prove a "sale" within the meaning of Code Section 1222(3). However, once these fallacies have been eliminated, and the transaction recognized for what the trier of facts found it was—a good faith arm's length disposition of stock at a negotiated price within a reasonable range—the transaction is demonstrably a "sale" as this and other Courts have always construed the term.

Not only is the Commissioner's solution to this problem based upon erroneous postulates, but it would do violence to one of the most deeply-embedded and thoroughly-settled axioms of the tax law—the concept of realization. When the Commissioner's straw man argument is disposed of, there remains of his contention (Br. p. 27) only the argument that a "sale" cannot occur without the shift of the primary business risks from seller to buyer, and the related argument that there can be no "sale" where the amount or the timing of the payments are dependent upon subsequent profits. How-

ever, these arguments are untenable, as a review of basic principles and the decided cases will demonstrate.

On September 30, 1946 Clay Brown and his family acquired 30,000 shares of stock of Clay Brown & Company, an Oregon corporation, for $30,000. By 1953 due to the substantial accumulated tax-paid corporate earned surplus and the demonstrated corporate earning power, the value of the stock had appreciated to about $1,175,000 [R. p. 64].[20a] The Browns' annual increments of value of the stock went currently untaxed, however, because the American taxing system does not treat mere accrued gains in value as current income, but rather waits for an event which changes the nature of the taxpayer's interest in some sufficiently consequential manner to be noticed by the tax law, and on the occurrence of such a conversion taxes the total accrued gains at one time. *Eisner v. Macomber,* 252 U. S. 189 (1920).

Such a realizing event, when it involves a reciprocal complete disposition of legal property interests with another legal entity is an "exchange." *Helvering v. William Flaccus Oak Leather Co.,* 313 U. S. 247, 249 (1941). An exchange (and therefore a realizing transaction) occurs whenever a capital asset is converted into some significantly different asset. For example, in the early landmark case of *Marr v. United States,* 268 U. S. 536 (1925), this Court held that gain was realized by a General Motors stockholder when that corporation was merely reorganized from a New Jersey to a Delaware corporation, and the taxpayer's New Jersey shares were exchanged for Delaware shares representing the

[20a] This includes the price paid for a small number of shares owned outside the family which are ignored here for simplicity.

identical underlying business and assets. Mr. Justice Brandeis said:

> The government insists that identity of the business enterprise is not conclusive; that gain in value resulting from profits is taxable as income, not only when it is represented by an interest in a different business enterprise or property, but also when it is represented by an essentially different interest in the same business enterprise or property; that, in the case at bar, the gain actually made is represented by securities with essentially different characteristics in an essentially different corporation; and that, consequently, the additional value of the new securities, although they are still held by the Marrs, is income under the rule applied in United States v. Phellis, 257 U. S. 156, 42 S. Ct. 63; Rockefeller v. United States, 257 U. S. 176, 42 S. Ct. 68; and Cullinan v. Walker, 262 U. S. 134, 43 S. Ct. 495. In our opinion the government is right. (268 U. S. at 540.)[21]

In other words, termination of business risk, as such, has nothing to do with whether a transaction is a realizing transaction.

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[21]Today, gain realized on such a transaction would not be *recognized*, by virtue of §§ 354 and 368(a)(1)(F). This does not weaken the validity of the principle of realization or change the character of the transaction as an exchange. The nonrecognition provisions are construed strictly, and must be met both in letter and in spirit. *Gregory v. Helvering*, 293 U. S. 465 (1935); *LeTulle v. Scofield*, 308 U. S. 415 (1940); *Turnbow v. Commissioner*, 368 U. S. 337 (1961); *Bazley v. Commissioner*, 331 U. S. 737 (1947). For example, there would be a recognition of gain on such a transaction if one of the corporations was a foreign corporation and no advance ruling was obtained under § 367. *Cf. Texas-Canadian Oil Corp.*, 44 B. T. A. 913 (1941).

A "sale" is merely a special form of exchange in which the other party delivers or agrees to pay cash, instead of other property, for an asset. A sale, like any other exchange, is a realizing transaction, on which the accumulated increments of value over the prior years are recognized because of their conversion into something different, *i.e.*, cash or notes evidencing the right to cash. See *Merchants' Loan & Trust Co. v. Smietanka*, 255 U. S. 509 (1921); *Hays v. Gauley Mountain Coal Co.*, 247 U. S. 189 (1918); *United States v. Cleveland, C., C. & St. L. Ry.*, 247 U. S. 195 (1918); *MacLaughlin v. Alliance Insurance Co.*, 286 U. S. 244 (1932); *Jordan Marsh Co. v. Commissioner*, 269 F. 2d 453, 456 (2d Cir. 1959). The degree of risk and uncertainty surrounding the cash to be received may affect the year of recognition. *Burnet v. Logan*, 283 U. S. 404 (1931). They do not alter the *fact* of recognition or the characterization of the transaction as a *sale*. *LeTulle v. Scofield*, 308 U. S. 415 (1940).

The doctrine of realization has been said to be "one of the two or three significant contributions of the Supreme Court in the field of income taxation . . ." Magill, *Taxable Income*, 47 (Rev. Ed. 1945). It is basic and fundamental, and (at least since certain contrary dicta in *Lynch v. Turrish*, 247 U. S. 221, 229-230 (1918) were impliedly overruled by *Merchants' Loan & Trust Co. v. Smietanka, supra*) this Court has never failed to hold that gain is realized on the occurrence of such a transaction. In fact, if anything, this Court has become even readier to find that realization of income has occurred. Compare *Helvering v. Bruun*, 309 U. S. 461 (1940) *with Eisner v. Macomber*, 252 U. S. 189 (1920).

The structure of the Code provisions on this point is clear. Whenever an asset which has appreciated in value is disposed of for cash, a right to cash, or any other property, gain is realized. Sections 1001(a); 1001(b). Except as expressly provided in one of the various nonrecognition provisions of the income tax subtitle, this gain must be recognized and included in the taxpayer's gross income for the year of realization under Section 61(a)(3). Section 1002; *Turnbow v. Commissioner*, 368 U. S. 337 (1961).

The long-term capital gains provisions are a corollary of this doctrine of realization. Their principal purpose is to avoid "bunching" at ordinary rates in the year of the realizing event—the "sale or exchange"—of all of the previously accrued but hitherto unrealized gains of prior years.[22] Where there are gains on the realizing conversion of a capital asset into cash, they will be capital gains. To hold otherwise, at least in a good faith bargained transaction at a realistic price, is to deprive the taxpayer of the tax treatment Congress clearly intended, and to award an unintended windfall to the Government.

In 1953 the Browns entered into the transactions here in question. They transferred their stock and notes to the Institute, which agreed to and did immediately liquidate the corporation, and gave respondents in exchange for the stock and notes its note for $1,300,000 maturing in ten years, and secured in effect by first liens on all of the former corporation's

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[22]See, *e.g.*, *Commissioner v. Gillette Motor Transp. Inc.*, 364 U. S. 130, 134 (1960); *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260, 265 (1958); *Helvering v. Hammel*, 311 U. S. 504, 509 (1941); *Burnet v. Harmel*, 287 U. S. 103, 106 (1932).

assets. The transaction was admittedly genuine and not a "sham" (Br. p. 37). Although petitioner, as we have seen, argues the case as though the stock was transferred with a retained right to "dividends," there was no such right. A liquidated corporation declares no dividends. There was rather a clear conversion of the form of the respondents' investment, and therefore a realizing transaction.

2. Since Realization Occurs Even Where the Taxpayer Remains Dependent Upon and at the Economic Risk of Subsequent Declines in Earnings and Asset Values of the Income-Producing Asset Transferred, Such Continued Dependency and Risk Are Not Reasons for Denial of Long-Term Capital Gain Treatment on the Realized Gains.

Petitioner does not, apparently, rely on any contention that the sale qualified for nonrecognition under any of the nonrecognition provisions of the Code.[23] His theory is basically that because business risks continued to jeopardize receipt of the full $1,300,000, the transaction was not a realizing transaction at all, but the mere retention of an income interest, similar to that in *Burnet v. Harmel*, 287 U. S. 103 (1932) (Br. p. 45). The implication is that a substantial shift of business risk is a prerequisite to realization (Br. p. 37).

There are two compelling answers to this contention. First, even if a substantial shift of business risk *were* required, the requirement is easily satisfied in this case, as we have seen.[24] Secondly, and more fundamentally,

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[23]It is suggested at one point that there might have been a corporate reorganization (Br. pp. 73-74). *LeTulle v. Scofield*, 308 U. S. 415 (1940), squarely in point, suffices to rule out any such contention.

[24]See pp. 21-23 above.

no substantial shift of risk is required either for realization or for capital gain treatment. The Courts, notably including this Court, as well as Congress and even the petitioner himself, have repeatedly recognized that realization of gain on sales and exchanges does not require the taxpayer's freedom from the economic hazards associated with his original position. Such gains are even realized through mere shifts in the form of ownership of assets, without any hint of "shifting of the benefits and burdens of future gains and losses to others" or "relinquishment of the future for the present," to use petitioner's terms (Pet. p. 13). Thus, in *Marr v. United States, supra,* the shift of a corporate charter from one state to another was held to constitute a realizing exchange. In *Cullinan v. Walker,* 262 U. S. 134 (1923), the Court similarly held that gain was realized on a divisive reorganization in which the taxpayer in effect exchanged his stock in one corporation for stock and bonds in newly-formed corporations, with no "cashing in," or "relinquishment of the future for the present," but merely an altered form of ownership of the identical businsses and assets previously held through the original stock. The simplest case of such a realizing exchange, of course, is an ordinary corporate liquidation. Even if the stockholders of the corporation will immediately continue the same business in partnership or other form—remaining subject to all the business risks—it is clear that a realizing exchange has occurred, as long as the liquidation is genuine.[25] Similarly, the mere exchange of business assets for stock on the for-

[25] See, *e.g., Hellmich v. Hellman,* 276 U. S. 233 (1928); *United States v. Arcade Co.,* 203 F. 2d 230 (6th Cir. 1953); *Wessel v. United States,* 49 F. 2d 137 (8th Cir. 1931); Code § 331(a)(1).

mation of a corporation is a clear realizing transaction, and only Section 351 (where it applies) prevents recognition of gain thereon.

The absence of any prerequisite of shift of business risk was made particularly clear by this Court in *LeTulle v. Scofield,* 308 U. S. 415 (1940). In that case, the taxpayer conveyed certain properties to his wholly-owned corporation, which then exchanged these assets and others which it had previously held with a new corporation for $50,000 in cash, and $750,000 in bonds of the new corporation payable serially over 10 years. The new corporation had little capital and the bonds would only be paid if the business succeeded, and were secured solely by the assets transferred. Upon default, the bondholders would retake only the property sold. *Scofield v. LeTulle,* 103 F. 2d 20, 22 (5th Cir. 1939). The taxpayer's old corporation was then liquidated. The Court of Appeals for the Fifth Circuit held that this transaction qualified in part as a tax-free reorganization, advancing the very grounds for characterizing it as something other than a "sale" which the Government now urges on this Court—*i.e.,* the down payment was minimal, and the bonds would only be paid off if the business succeeded, so that there had assertedly been an insufficient shift of business risk to cause recognition of the taxpayer's gains. 103 F. 2d at 22. This Court, however, disagreed, holding that despite the clear continuation of business risks by the sellers, the transaction was a *"sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange"* 308 U. S. at 421 (Emphasis added.)

In *Bull v. United States*, 295 U. S. 247 (1935), this Court cited with approval two earlier Court of Appeals cases which treated as sales transactions in which the interests of deceased partners were sold to their surviving partners, or the partnership, in exchange for payments to the estate by the surviving partners of amounts measured solely by post-death partnership earnings.[26] This Court said, citing these cases:

> Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a *sale*, and payments made to the estate are for the account of the survivors (295 U. S. at 254; Emphasis added).

In *Vermont Transit Co., Inc. v. Commissioner*, 218 F. 2d 468 (2d Cir. 1955), *cert. denied*, 349 U. S. 945 (1955), the taxpayer agreed to purchase certain franchises, with part of the consideration to consist of earnings from the franchises during the ensuing five-year period. This consideration was held to be part of the purchase price and not a mere retention by the seller of earnings, so that the buyer was required to include these amounts in his income. The Court said:

> Whether an agreement of purchase and sale has conveyed all of the property interests involved so as to make the purchaser fully taxable on all of the resultant earnings or whether the contract has reserved an interest in the seller on which the seller is taxable is a question of the intent of

[26] *Hill v. Commissioner*, 38 F. 2d 165 (1st Cir. 1930); *Pope v. Commissioner*, 39 F. 2d 420 (1st Cir. 1930); cited 295 U. S. at 254. To the same effect is *McKelvey v. Commissioner*, 246 F. 2d 609 (3d Cir. 1957).

the parties in making the agreement. This intent may be inferred from the wording of the agreement and from the surrounding circumstances. Thomas v. Perkins, 301 U. S. 655, 447 S. Ct. 911, 81 L. Ed. 1324; Anderson v. Helvering, 310 U. S. 404, 60 S. Ct. 952, 84 L. Ed. 1277. We agree with the conclusion of the Tax Court that the facts here point to the outright sale of a capital asset without reservation of interest (218 F. 2d at 469-470).

In *Nordberg Mfg. Co. v. Kuhl*, 16 F. 2d 331 (7th Cir. 1948), it was held that an arrangement under which dividends, if any, were to be applied to the liquidation of taxpayer corporation's preferred stock constituted a capital transaction (in effect a sale) and not a distribution of the corporation's earnings, so that the taxpayer received no dividend credit. *Cf. Hellmich v. Hellman*, 276 U. S. 233, 236-37 (1928); *Ayrton Metal Co. v. Commissioner*, 299 F. 2d 741, 748 (2d Cir. 1962); *Commissioner v. Ferrer*, 304 F. 2d 125, 131 (2d Cir. 1962).

Congress, too, has recognized the same principle. As recently as January, 1964, the Senate Finance Committee, in the following words, gave express recognition to the principle that there can be a sale or exchange of property even though payments depend on future income derived therefrom:

> Where, at the time of the *sale or exchange*, some or all of the payments are indefinite as to their size; *for example where the payments are in part at least dependent upon future income derived from the property*, the 'unstated' interest for purposes of this provision will be determined separately with respect to each indefinite payment as it is re-

ceived, taking into account the time interval between the sale or exchange and the receipt of the payment. S. Rep. No. 830, 88th Cong., 2d Sess. 103 (January, 1964) (emphasis added).

To identical effect is H.R. Rep. No. 749, 88th Cong., 1st Sess., 73 (1963).

This language referred to what is now Code Section 483(d), providing for imputed interest on "Payments That Are Indefinite as to Time, Liability, or Amount." Instead of providing for 100% ordinary income treatment, Congress was content in Section 483(d) to prevent capital gain treatment only for so much of these payments as constituted disguised interest. Congressional judgment *not* to treat such payments as 100% ordinary income, but only so to tax the imputed interest element, was clearly deliberate since the Secretary of the Treasury, at the time he requested Congress to enact legislation imputing interest on deferred payment sales (now Section 483), also asked Congress to provide ordinary income treatment for "payments on the sale of a capital asset (or payments so treated under present law) which are deferred over more than 5 years and are contingent on future income." *Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, Before House of Representatives Ways and Means Committee,* February 6, 1963, p. 91. The Secretary there conceded what petitioner (Br. p. 60) *now* denies.

> Under present law, capital gain treatment is sometimes available on the sale of an asset even though the seller retains an interest in the income that is produced by the asset. In such cases the taxpayer is able to continue to enjoy the principal

right of ownership—participation in the income produced by the asset—but is taxed at capital gains rates as if he had completely parted with ownership. In the case of contracts for the sale of such assets made after February 6, 1963, where the seller retains a long-term income interest, the proposal would treat as ordinary income, payments contingent on future income from the asset sold, or from the income-producing property underlying the asset sold. A payment would be regarded as so contingent on future income if it were contingent on productivity, sales, profitability, use or disposition of the asset sold or the underlying property. For example, the proposal would cover the sale of stock in a corporation where payment is contingent on dividends on the stock or productivity of the corporate assets.

. . . .

"Example 1

S owns all of the stock of M Corporation. The stock has an adjusted basis of $75,000 in S's hands. S sells the stock to P for $50,000 cash plus $300,000, payable only out of 75 percent of M Corporation's net profits in excess of the first $50,000 of such net profits. Under present law, assuming S would be entitled to cost recovery, he would offset his basis against the down payment and the first $25,000 of contingent payments and would receive capital gains treatment with respect to all subsequent payments. (Secretary's Statement at pp. 91-92.)

Had Congress desired to comply with the Secretary's request, it would have done so. Instead, it provided

the more limited provisions of Section 483(d). The situation in the present case could not be clearer. The petitioner expressly called to the attention of Congress the fact (which for his then purposes he unqualifiedly admitted) that 100% capital gain treatment was permitted where an asset is sold for a price contingent on earnings, and he requested Congress to substitute 100% ordinary income treatment. Congress considered the problem and responded with Section 483(d), which treats as ordinary income *only* the portion of such gains which constitutes imputed interest. Petitioner now asks this Court to do for it what Congress would not. So presumptuous an invitation to judicial legislation should be ignored. See *Hanover Bank v. Commissioner*, 369 U. S. 672 (1962), in which this Court said:

> With particular relevance to the Government's argument in the instant case, it is worthy of note that Congress understood the operation of the statute to the taxpayer's advantage, but limited correction of the abuses inherent in it to elimination of the quick write-off. (369 U. S. at 684.)

The decision made by this Court in *Hanover Bank* was, quite properly, to leave the legislating to Congress, even though the taxpayer in that case admittedly received something of a windfall. How much more the same decision should be reached in a case such as this where (because of the realistic price) the taxpayer claims *no* tax benefits not available on *any* installment sale and where it is the *Government* which demands a windfall through judicial legislation.

Congressional action in expressly providing that not even a *nominal* down payment is required in the year of sale for application of the installment sales provi-

sions further indicates Congressional disagreement with the petitioner's thesis here.[26a] Sales with no down payment are not in practice usually made where the purchaser has substantial independent assets—if he had them he would use them to make a down payment. Even the Service was always satisfied with a *nominal* down payment. G. C. M. 12148, XII-2 C. B. 57 (1933).

Even the Commissioner does not customarily contend that a complete disposition of an asset is not a sale merely because the cash payments are at risk or are contingent on the productivity of the asset transferred. Thus he acquiesced, 1960-2 C. B. 7, in the Tax Court's opinion in *W. H. Truschel,* 29 T. C. 433 (1957). In this case the petitioners, stockholders of Pocahontas Tanning Company, sold their stock to a "feeder corporation" for short-term notes and bonds of the feeder, into which Pocahontas was merged. The Commissioner pointed out that because the feeder had only $1,000 of capital soock and $22,000,000 of bonds, the bonds were entirely at the risk of the business. Contending that this made the bonds the equivalent of equity, despite the fixed maturity date and fixed rate of interest, the Commissioner argued the transaction was not a sale but a reorganization. The Court, relying on *LeTulle v. Scofield, supra,* held it was a sale, resulting in long-term capital gains to the selling shareholders. Petitioner's published acquiescence in this case, which is still of record and has not been withdrawn, demonstrates his agreement with the proposition that a sale is

[26a] *Compare* G. C. M. 12148, XII-2 C. B. 57 (1933) and Treas. Reg. § 39.44-2(c) under Section 44(b) of the 1939 Code, *with* Section 453(b) of the 1954 Code. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 64 (1954).

nonetheless a sale, and nonetheless entitled to long-term capital gain treatment, even in the absence of independent risk capital and despite the continuation of business risk.

In a recent Revenue Ruling, the Commissioner considered the case of a donation of a remainder interest in property to charity, with a life estate retained in the income from the property. Because the terms of the transaction required the immediate disposition of the property by the charity in a realizing transaction and the conversion of the proceeds into other assets, the Commissioner expressly held that the transaction constituted not the mere retention of an income interest, but a realizing and recognizing sale or exchange. Rev. Rul. 60-370, 1960-2 C.B. 203. We see absolutely no tenable distinction between this transaction and the one before this Court on the basis of which it could be argued that the former was a realizing exchange and the present case a mere reserved income interest.

Similarly, in Rev. Rul. 58-353, 1958-2 C.B. 408, the Commissioner indicated his agreement with the now well-settled principle that a patent assignment constitutes a sale for tax purposes despite payments measured by the productivity of the transferred asset and payable over a period generally coterminous with its use. This is particularly embarrassing to the Commissioner in the present case because this case is a much clearer one for capital gains treatment, in that it involves a *fixed* sales price, payable over a relatively *short* period, for an asset which (unlike a patent) was *not* inherently exhaustible. Certainly the repeated rebuffs in the patent area to the Commissioner's theories—both from the

courts and the legislature—have pained him, and this court has already had occasion to comment upon his "obduracy" in these matters. *United States v. Zacks*, 375 U. S. 59, 69-70 (1963). However, the Commissioner having finally published his agreement with the conclusions of the courts, it is a bit surprising to read in his brief (pp. 68-69; & n.41) that the cases relied on in Rev. Rul. 58-353 are "wrong in principle" and that the Ruling merely meant the Service "was forced to cease litigating the question, at least for the time being." This is particularly true since the Commissioner *sua sponte* subsequently extended the principle of Rev. Rul. 58-353 into the copyright area, without citing any copyright cases forcing such a decision, Rev. Rul. 60-226, 1960-1 C.B. 26, and since as recently as February, 1963 the Secretary of the Treasury officially reiterated this understanding of the law and requested *non-retroactive* legislative correction—which Congress refused.[27] We had thought that Rev. Rul. 58-353 represented more than a temporary surcease of the Commissioner's "obduracy" in the patent field, and that this question was well laid to rest.[28] Be that as it may, there is no need to consider the patent cases further since there is little resemblance between the typical patent assignment and the present sale of stock for a fixed cash price within a reasonable range.

On the basis of the above-cited authorities, it is clear that the dispositions by respondents of their stock in

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[27] *Statement by Secretary of the Treasury and Technical Explanation on President's Tax Reduction and Reform Message, Before House of Representatives Ways and Means Committee* (February 6, 1963) pp. 91-92.

[28] Despite petitioner's position in this case, neither Rev. Rul. 58-353 nor Rev. Rul. 60-226 have been rescinded and numerous taxpayers enter daily into long-term transactions in reliance upon them. See also Rev. Rul. 62-81, 1962-1 C. B. 153.

Clay Brown & Co. on February 4, 1953 constituted sales. There was at that point of time a shift in the rights of the respondents of fully sufficient substantiality to satisfy the doctrine of *Marr v. United States, supra* (in which the shift was much less than that in the case at bench). Before the sales, respondents owned stock in a going Oregon corporation. This was irrevocably surrendered to the Institute in return solely for a right to cash, and cash was all that respondents got. Moreover, as an essential and agreed part of the transaction the corporation was liquidated [R. pp. 198-199]. This liquidation *alone* would have sufficed to produce both realization and recognition of the entire accumulated gain at long-term capital gain rates, even if the assets of the liquidated corporation had been *retained* by respondents. Since none of these assets were retained, but instead became the property of the Institute, while respondents received only a cash down payment and the Institute's promissory notes, it is even clearer that a realizing transaction, and a sale, took place. The above authorities adequately demonstrate that this is true, regardless of the extent to which payment of the notes depends on the subsequent success of the underlying business enterprise.

Furthermore, to gloss over the corporate liquidation in this case and treat the transaction as if a right to dividends on the stock *were* retained, rather than the right to payment of $1,300,000 in installments equal to 90% of the income (before taxes and depreciation) to be earned by rental of the business and assets of the former corporation, completely ignores the existence of the corporate entity—the difference between stock and assets. It ignores the distinction drawn in the very oil and gas cases on which petitioner primarily relies

between the *retention* of a reserved royalty right when the taxpayer transfers the remainder of his lease rights (*not* a realizing transaction), and the *sale* of stock in a corporation, even if payment therefor is to be made in cash measured by the productivity of the corporate assets (a realizing transaction). Compare *Burnet v. Harmel,* 287 U. S. 103 (1932) with *Helvering v. O'Donnell,* 303 U. S. 370 (1938). This Court held in *O'Donnell* that since the taxpayer sold stock, not oil in place, he was not selling (and could not be reserving any depletable interest in) the underlying corporate assets. Thus the liquidation in this case stands as an impenetrable barrier to the petitioner's "reserved income" theory. The barrier is the corporate entity itself, which may not simply be ignored for tax purposes to suit the convenience of either party. *Moline Properties, Inc. v. Commissioner,* 319 U. S. 436 (1943); *Burnet v. Commonwealth Improvement Co.,* 287 U. S. 415 (1932).

The fact that payments were made over a period of years does not weaken this argument, since it is only by virtue of respondents' exercise of their statutory privilege of reporting on the installment basis that they are permitted to spread their realized and recognized gains over the period of payment. Internal Revenue Code Section 453. A sale cannot be less a sale because this election is made. A sale or exchange is not in any event deprived of its capital nature merely because the gain or loss may be spread over a number of years. See, *e.g., Arrowsmith v. Commissioner,* 344 U. S. 6 (1952); Code Section 346(a)(1); *Sara A. Young,* 16 T. C. 1424 (1951); *Cf. Burnet v. Logan,* 283 U. S. 404 (1931).

Moreover, it is a well-settled principle that neither the government nor the taxpayer may focus on a single

step and ignore the other steps in an integrated series of steps making one transaction. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U. S. 179, 184-185 (1942); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. Tax Inst. 247 (1954). Thus, even if the transaction in question amounted merely to the retention of a right to dividends (as the government hypothesizes), if it had been immediately followed by a liquidation in accordance with a prearranged plan, the substance of the transaction would under this principle be treated for what it was by integrating the two steps. *A fortiori*, the government cannot properly break into two steps a transaction which, in fact, consisted of only one, in order to assess a tax on its theory of what the appropriate tax results would be on the first nonexistent and hypothetical step.

B. Any Economically Genuine Final Disposition of a Capital Asset for a Cash Price Constitutes a Sale.

1. The Term "Sale" Used in I.R.C. Section 1222 Should Be Given Its Normal Meaning.

Despite the frequency with which the term "sale" is used in the Code, it is nowhere expressly defined. As we have indicated, however, its use in the phrase "sale or exchange," and the fact that long-term capital gain treatment is a statutory corollary of the doctrine of realization, show that a sale is simply a realizing transaction in which an asset is transferred to another party in exchange for cash or the right to cash—in effect a particular category of exchange. Since the noncontinuation of risk has nothing to do with capital gain treatment on any other exchange, there is no good

reason to read such a requirement into the definition of a sale.

Further support for this view is found in this Court's repeated holdings that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary everyday senses." *Hanover Bank v. Commissioner,* 369 U. S. 672, 687 (1962); *Crane v. Commissioner,* 331 U. S. 1, 6 (1947).[29] This principle applies to the term "sale or exchange" no less than to any other statutory language. *Helvering v. William Flaccus Oak Leather Co.,* 313 U. S. 247, 249 (1941).

The principle of giving words their normal meaning has been applied even where it resulted in unusual benefits to taxpayers. *E.g., Hanover Bank v. Commissioner, supra; Commissioner v. Korell,* 339 U. S. 619 (1950). It is even more clearly applicable where the normal meaning of the word "sale" is entirely in harmony with the statutory scheme and would give the taxpayers no unusual benefits, and where the contrary interpretation would provide a windfall to the government at taxpayers' expense. *Helvering v. Hammel,* 311 U. S. 504, 510-511 (1941); *Lewyt Corp. v. Commissioner,* 349 U. S. 237 (1955). The statutory intent of the long-term capital gains provision, as we have seen, is largely to moderate the "bunching" effect which would otherwise result from the inclusion of the entire gain in the income of the year of the realizing event.[30]

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[29]See *Commissioner v. Korell,* 339 U. S. 619, 627-28 (1950); *Lang v. Commissioner,* 289 U. S. 109, 111 (1933); *Lynch v. Alworth-Stephens Co.,* 267 U. S. 364, 369-70 (1925); *Old Colony R. v. Commissioner,* 284 U. S. 552, 560 (1932); *Cf. Braunstein v Commissioner,* 374 U. S. 65 (1963); *Gilbert v. United States,* 370 U. S. 650 (1962).

[30]See cases cited note 22.

In the present case, most or all of the bargained-for price, and certainly all of the $936,131.85 actually paid, represented return of respondents' basis and beyond that realization in cash of the very type of accretion in value over a period of years to which the long-term capital gains provisions were primarily intended to be applicable. In fact, the corporate book net worth alone (invested capital, notes, and corporate earned surplus) at the time of the transfer was $619,457.63 [R. p. 22], or 66.2% of respondents' total receipts. It follows that long-term capital gain treatment is demanded by the statutory purpose, and if the normal meaning of "sale" includes the present transaction this Court should not characterize it as something else. This is particularly true where the petitioner's recommended characterization—"retention of an income interest"—is not only inconsistent with the statutory purpose and the commonly accepted meaning of "sale," but also as we have seen does such violence to the basic doctrine of realization.

Still further reason for the application of the normal meaning of the words is found in that Congress was fully aware of the pattern of so-called "bootstrap" sales to charities and took action thereon in the 1950 amendments *without* electing to change the tax consequences to sellers. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-40 (1950). Because of this Congressional action, as well as Congressional refusal in the Revenue Act of 1964 to do by statute what petitioner now seeks to have done by decision,[31] it is all the clearer that this Court should not torture the expression "sale or exchange" from its normal meaning to exclude a sale of the type here involved.

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[31] See pp. 52-54, 57 above.

2. The Transaction in Question Fits the Normal Meaning of the Word "Sale."

The term "sale" in common usage does not exclude transactions where the right to cash installments is subject to risk, or even where the price itself (unlike that of the present case) varies with the subsequent productivity of the asset transferred. This is shown by this Court's characterization as a "sale or exchange" of the transfers in *LeTulle v. Scofield, supra,* in which payment was almost completely at risk, and of the transaction in *Burnet v. Logan,* 283 U. S. 404, 412 (1931), in which the price depended on the productivity of the asset transferred. It is shown by the holding and language of this Court in *Helvering v. O'Donnell,* 303 U. S. 370 (1938), in which the taxpayer transferred his stock for a one-third net profits interest in certain oil and gas properties owned by his corporation. Unlike our case, there was no fixed price, and also unlike our case payment was *entirely* contingent upon net profits, with no reservation of a lien on the properties. Nevertheless, the Court, speaking by Mr. Chief Justice Hughes, called the transaction a "sale" of stock, and denied depletion to the seller.

Likewise, in *Anderson v. Helvering,* 310 U. S. 404 (1940), the taxpayer transferred certain oil property interests for a fixed price of $160,000, payable $50,000 in cash and $110,000 from proceeds of oil and gas produced. A lien was reserved (as in this case) on part of the property conveyed. As here, the parties clearly intended a sale. This Court held that:

> The deferred payments reserved . . . must be treated as payments received upon a sale to petitioners. . . . (310 U. S. at 413.)

In *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934), the taxpayer sold goods on open account and unsecured notes, apparently with no down payment, for $39,983.27 to a purchaser which in the same year became bankrupt. Although the taxpayer eventually collected a far smaller proportion (27½%) of the debt in that case than did respondents in the present case, the Court characterized the transaction, despite its risky nature, as a "sale" (and indeed, before the advent of the novel theories set forth in petitioner's brief, it is doubtful that anybody would have considered that it might not be).

In non-tax cases, this Court has also defined the term "sale" with no indication that characterization as a sale depended upon the certainty of payment rather than the finality of disposition. In *Williamson v. Berry*, 49 U. S. (8 How.) 495 (1850), the Court stated, holding that a deed for a non-cash consideration was not a sale:

> . . . . *sale* is a word of precise legal import, both at law and in equity. It means, at all times, a contract between parties, to give and to pass rights of property for money—which the buyer pays or promises to pay to the seller for the thing bought and sold. . . . (49 U. S. at 544).

In *Iowa v. McFarland*, 110 U. S. 471, 478 (1884), the Court said:

> A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent.[32]

[32]See also *Waterman v. Mackenzie*, 138 U. S. 252 (1891).

The common understanding of what constitutes a sale was well expressed by Judge Madden in *Union Bank v. United States,* 285 F. 2d 126 (Ct. Cl. 1961), as follows:

> From the standpoint of the Goldenbergs, they were, before the 1951 transaction, the owners of valuable properties and a valuable going business. . . . After the 1951 transaction the Goldenbergs had no interest in these assets except a security interest, the power to take them back in case of default in payment for them. If they increased in value because of general prosperity or business success, or in dollar value because of inflation, the Goldenbergs would get no part of that important incident of ownership. . . . They did not and will not get the property back, and when the final payment is made by the Foundation in 1961, even their security interest in the property will be gone, and they will have no relation whatever to it.
>
> *We think it is logically and legally impossible for an owner to part with his property, for a consideration, without selling it.* The consideration which he gets for parting with his property is not income from the property, but is the price of his parting with the property. (285 F. 2d at 128.) (Emphasis added.)

If any source authoritatively indicates the common understanding of a "sale," it would be the Uniform Acts on the subject. Neither the Uniform Sales Act nor the Uniform Commercial Code, however, contain any hint of support for the idea that substantial risk of payment negates a sale. The Uniform Sales Act definition of a Sale (Section 1(2)) is as follows:

> A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price.[33]

The Uniform Commercial Code, § 2-106(1) provides:

> A 'sale' consists in the passing of title from the seller to the buyer for a price (Section 2-401).

Either the Uniform Sales Act or the Uniform Commercial Code are in force today in most states of the Union. They state authoritatively the well understood meaning of the term "sale." It does not require certainty of payment or absence of risk. It does require the transfer of property in the goods or passage of title, *i.e.*, a complete disposition. Under the above definitions there can be no legitimate doubt that the transactions here in question constituted a sale.[34]

C. Characterization of the Present Transaction as Anything Other Than a Sale Creates Serious Distortions and Unnecessary Problems.

In the last analysis, this case involves a group of stockholders whose stock had greatly appreciated in value, and who irrevocably transferred the stock, and certain notes, receiving in exchange from the transferee cash in the amount of $936,131.85, and nothing else [R. p. 56]. If the transaction is characterized as a sale for tax purposes (and it would assuredly be so characterized for any other purposes), no particular problems arise and no uncalled-for tax benefits are con-

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[33]See Williston, Sales, §§ 1, 2 (rev. ed. 1948).

[34]Even petitioner himself, on page 29 of his Petition, betrays his own understanding of the normal meaning of the term "sale," when he observes that respondents' stock was "sold to the Institute," neglecting the clothing of quotation marks with which he has elsewhere so assiduously disassociated himself from the term.

ferred. The taxpayers have simply reclaimed their investment in the stock and notes and realized, recognized and paid tax on appreciation enjoyed by their stock over the years they owned it up to the time of final disposition. The provisions of the Code relating to sales and exchanges are designed for and nicely cover such a transaction.

Were this Court to leave the beaten path provided by the statute and strike out through the uncharted and thorny thickets suggested by the petitioner, it would be immediately beset by a wide range of questions which petitioner has not answered. Nor will it do to shrug and leave such problems for the lower courts, as petitioner suggests (Pet. p. 23, n. 29). This Court recently refused to embark upon such an expedition in *Braunstein v. Commissioner*, 374 U. S. 65 (1963), and it is not difficult to demonstrate that far worse difficulties await here if the Court accepts petitioner's new and artificial distinction between final dispositions of capital assets for cash installments according to the seller's degree of risk.

In the first place, petitioner points to no satisfactory way within the charted statutory paths to give adequate recognition to the fact that the seller's basis is used up as payments are made. If the transaction is the "reservation of an income interest," the seller will one day have received his entire agreed price. What then? If the payments are treated as "dividends," there is no provision for cost recovery, and the seller is treated as receiving income which in fact he never received. Should each "dividend" be treated as in part a return of basis? Or should the taxpayer receive merely a capital loss on the last payment? The statute.

which never contemplated a category of complete cash dispositions which are not sales, is silent.

Secondly, the petitioner's novel proposed elevation of the degree of risk into the watershed between "sale" and "reserved income" treatment raises a host of new questions. How is a seller to know how risky his transaction can be and still constitute a sale? Will a subjective or objective standard of risk be employed? If the post-sale value of the business drops by an amount equal to the down payment, or if the buyer's other assets are lost, will subsequent installments become dividends? Conversely, in the low down payment case, will a post-sale *rise* in value sufficient to give the buyer a substantial equity convert subsequent installments into receipts of sale proceeds? Moreover, with this Court's decisions guiding the practical world of commerce all over the nation, it is scarcely satisfactory for this Court to wash its hands of responsibility for creating hitherto unheard-of ambiguities by stating, as petitioner glibly suggests, that whether a final cash disposition is too risky to be a sale is a "question of degree" (Br. p. 58). Any such doctrine would create the most serious uncertainties for a host of bona fide sales and exchanges characterized by retention of high risks.

A single example will illustrate this. In rapidly growing Southern California, hundreds of millions of dollars worth of land changes hands annually, as great areas of farmland become suburban subdivisions. The land is sold from the original owner to the developer who in turn sells to the ultimate land users. Land worth not over $1,000 per acre for grazing or raising barley increases in value as subdivision property to $25,000 per acre or more. The developer rarely

makes a substantial down payment, and under California law he has no personal liability to pay the contract price.[35] Consequently, the landowner's receipt of his $25,000 per acre is almost completely dependent upon the developer's sales proceeds. The developers in turn sell to ultimate users—*e.g.*, homeowners. These sales are also non-recourse under the law but are also typically almost 100% financed, with the developer taking back second deeds of trust or installment sales contracts. Until now, nobody has doubted that all these transactions were "sales." Under petitioner's proposed criteria, these "sales" would apparently not be "sales" at all for tax purposes, because the sellers' payments would remain at risk. If adopted by this Court, these theories would cast grave doubt on the tax consequences of probably billions of dollars of transactions in this State alone.

Moreover, adoption of the petitioner's approach would produce a gaping disparity between the tax treatment of sales and exchanges. As we have seen, exchanges occur without reference to the retention or non-retention of business risk—and petitioner has not explained why sales should differ, thereby creating a tension between the two which has not heretofore existed, with unforeseeable consequences.

The term "sale" is central in the Code. The words "sale" and "sales" appear 635 times in Subtitle A alone (by computer search). The distortion of such a term by introducing the hitherto unheard-of concept of a maximum permissible risk of payment in otherwise

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[35]In California there can be no deficiency judgment on a sale of real property where there is a lien on the property sold. Code of Civil Procedure § 580(b).

arm's-length negotiated transactions would have literally unimaginable consequences in a multitude of other areas. Surely the parties themselves, at least in a bona fide negotiated transaction which makes economic sense, such as this one, are the best judges of what constitutes adequate security. The adoption of such a far-reaching and novel limitation on the concept of sale simply to gratify petitioner's desire (Pet. p. 30) for judicial legislation to discourage sales to charities would be using a sledge-hammer to kill the gnat.

There is no way to predict the widespread repercussions in a host of other areas which would be created by a redefinition of the term "sales" to include only more-or-less risk-free transactions. A few examples are already apparent, however. If a residence is transferred on the usual low down payment, non-recourse basis, will it be a "sale" for purposes of Section 1034? Will a homeowner who is over 65 find that gain he had thought to be exempt under Section 121 will now be taxable because the transfer of his residence was on terms too risky to be a "sale"?[36] If stock in a foreign corporation is transferred for an inadequately secured agreed cash consideration, will this be a "sale or exchange" for purposes of Section 1246? If oil or gas property is transferred without adequate security or personal liability of the transferee, will Section 632 apply? If stock in a collapsible corporation is disposed of on such terms, will Section 341 be inapplicable because there was no "sale or exchange"?

[36]In fact if petitioner's analysis is followed, the aged homeowner would apparently be taxed (and at ordinary rates) not only on his *gain* but on the entire sales proceeds as they come in! If this seems unfair to the homeowner, the same treatment is also unfair to respondents.

If Section 1245 property is so disposed of, will Section 1245(a)(1)(B)(i) (sales and exchanges) or Section 1245(a)(1)(B)(ii) (other dispositions) apply to determine Section 1245 gain? Will Section 483, applying to contracts for sale or exchange of property, apply to permit an interest deduction to the "buyer" if the seller did not make a "sale"? If a California landowner sells lots on the customary high-risk, low down payment basis, will he then be able to claim long-term capital gain treatment on a subsequent *cash* sale because he did not "hold his property for *sale* to customers in the ordinary course of his trade or business"? (Section 1221(1)). How would petitioner characterize a high-risk sale of non-income producing property?—*e.g.*, sale of a used car to a judgment-proof buyer. If it is not a "sale" because of the high risk, and is not a reservation of an income interest—because there is no income—what is it?

Enough has been said to indicate only the very threshold of the problems which would be created by leaving the statutory path and creating a hitherto unheard-of category of final dispositions of capital assets for a fixed cash consideration which are not "sales or exchanges." The problems are formidable. Only the sternest necessity should persuade this Court to embark on this new path—and not petitioner's mere desire to obtain a tax windfall from respondents in this case. If petitioner really believes that the term "sale" needs such redefinition, he should knock once more on the doors of the legislature.[37]

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[37]See pp. 52-54, 57, 62.

III.

THE OIL AND GAS CASES UPON WHICH PETITIONER RELIES IN FACT DEMONSTRATE THE OPPOSITE OF HIS CONTENTION.

Petitioner relies primarily upon a series of cases in the technical and specialized field of oil and gas taxation (Br. pp. 44-49). There are serious doubts as to the extent to which analogies from this line of authority can properly be applied in other fields, since tax concepts in the oil and gas field are informed by the exhaustible nature of oil and gas; by the provision for recovery of capital investment through the unique and all-important concept of percentage depletion; and by the concept that an oil and gas lease resembles "a manufacturing business carried on by the use of soil, to which the passing of title of the minerals is but an incident, rather than a sale of the land. . . ." *Burnet v. Harmel,* 287 U. S. 103, 107 (1932). Be that as it may, it is crystal-clear from the oil and gas cases that if they *are* accepted as persuasive authority for the present case, they only lend further support to the respondents' position that a sale occurred, rather than to the petitioner's view that there was a mere reservation of an economic interest.

Transactions in the oil and gas field cover a wide range, varying from a clear sale of property to a clear lease situation, with many puzzling gradations in between. In the case of an outright sale for a fixed cash consideration, the seller receives capital gain treatment and gets no further depletion allowance, while the buyer must report (as ordinary income) all the income subsequently derived from the purchased property, but receives the full depletion allowance against such income.

> It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest. . . .
>
> By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. *Anderson v. Helvering,* 310 U. S. 404, 407-408 (1940).

In the case of a mineral lease in which the owner of an interest in mineral land contracts with an operator to develop the property, retaining part of the oil produced as a royalty with the remainder going to the operator, the tax consequences are equally clear. There is no "sale" but a mere withholding of the retained interest, and the operator agrees to pay no fixed amount of cash. Therefore the income from the owner's retained interest continues to be ordinary income to the owner, and is subject to the depletion allowance. *Burnet v. Harmel,* 287 U. S. 103 (1932); *Palmer v. Bender,* 287 U. S. 551 (1933). The same result follows if the owner retains a right to the gross cash proceeds from the retained oil, instead of a property interest in the oil in place,[38] and later decisions ex-

[38]See *Helvering v. Twin Bell Oil Syndicate,* 293 U. S. 312 (1934); *Anderson v. Helvering,* 310 U. S. 404, 412 (1940).

tend the principle to the retention of a participation in net profits.[39]

A closer question is posed by the reservation of an "in-oil payment." Under this arrangement, the property owner reserves a given percentage of the minerals produced up to a stated sum, after which the property owner takes nothing further. This is closer to a true "sale," because there is a fixed maximum recovery. However, it is still treated as a retention or withholding, hence depletable, because in essence the owner has still merely carved out and reserved a portion of the income from his property, and has not transferred that portion. *Thomas v. Perkins*, 301 U. S. 655 (1937). As this Court stated in *Anderson v. Helvering, supra:*

> The holder of an oil payment right, as an original proposition, might be regarded as having no capital investment in the oil and gas in place. The value of the right, even though dependent upon the extent of the oil reserves, is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments. Yet it does depend upon the production of oil, ordinarily can be realized upon only over a period of years, and permits of a simple and convenient allocation between lessor and lessee of both the gross income derived from production and the allowance for depletion. Compare Burnet v. Harmel, 287 U. S. 103, 106, 107, 53 S. Ct. 74, 75, 77 L. Ed.

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[39] *Kirby Petroleum Co. v. Commissioner*, 326 U. S. 599 (1946); *Burton-Sutton Oil Co. v. Commissioner*, 328 U. S. 25 (1946).

> 199. Accordingly, this Court in Thomas v. Perkins decided that the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, and should be given the same tax consequences as a provision for oil royalties. (310 U. S. at pp. 410-411.)

Thomas v. Perkins, supra, marks the limit to which the doctrine of "reserved economic interest" can be stretched in the oil and gas field. As the Court in *Anderson v. Helvering* indicated, it could have gone either way, and the actual result was strongly influenced by the depletion allowance. Interestingly, Mr. Justice Stone, who wrote the Court's opinions in both *Burnet v. Harmel* and *Palmer v. Bender,* dissented (together with Mr. Justice Cardozo) in *Thomas v. Perkins.*

Petitioner relies principally on *Thomas v. Perkins* (Br. pp. 45-46). However, even if the principle of that case could be separated from the depletion allowance which gave it birth and could be elevated to a universally applicable measure of what constitutes a sale, other decisions of this Court make it clear that it would *not* apply to the present facts.

Under these decisions there are two requirements for the retention of a depletable economic interest (which as we have seen involves the "same basic issue" as the issue of whether a sale has occurred). (1) Acquisition by investment of "any interest in the oil in place," and (2) securing by legal relationship of "income derived from the extraction of the oil, to which he must look for a return of his capital." *Commissioner v. South-*

west Exploration Co., 350 U. S. 308, 314 (1956); *Palmer v. Bender*, 287 U. S. 551, 557 (1933). Neither requirement is met on the present facts, even if we follow petitioner's lead and consider the earning of business income to be analogous to extraction of oil.

(1) The retention of an interest in the "oil in place" is not met because respondents never had a direct interest in the business assets or income. They owned only stock in the corporation. In *Helvering v. O'Donnell*, 303 U. S. 307 (1938), this Court denied a depletion deduction to a stockholder who exchanged his stock in a corporation which owned oil leases for a share of the net income from production of the leased wells. The deduction was denied because, as a mere shareholder, he had no direct interest in the oil properties, and could retain none. He had therefore made a "sale" of his stock. Petitioner (Br. p. 47, n. 26) contends the case was later "all but overruled," apparently on the theory that it turned on the fact the royalty was based on "net income," and "net income" royalties have been subsequently held depletable. This misses the point of the opinion, which was stated by the Court in the following clear language:

> The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place. [Citations omitted.] As a mere owner of shares in the San Gabriel Company, respondent had no such interest. Treasury Regulations No. 69, art. 201. The ownership of the oil and gas properties was in the corporation. When the Midway Company acquired these properties from the San Gabriel Company and operated them, the Midway Company became the owner of the

> oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. (303 U. S. at 371.)

The fact that *O'Donnell* stands for the proposition that a stockholder cannot retain an income interest in his *corporation's* income-producing properties is confirmed by the cases of *Haynes v. United States,* 50 F. Supp. 238 (Ct. Cl. 1943) and *Tuttle v. United States,* 101 F. Supp. 532 (Ct. Cl. 1951), applying *O'Donnell* to permit capital gain treatment of proceeds of sales of stock in exchange not for *net profits* interests but ordinary oil royalties and (in *Tuttle*) an oil payment. It is significant that *Tuttle* was decided five years *after O'Donnell* was (supposedly) "all but overruled."[40]

Even petitioner's Regulations make clear that the distinction drawn in *O'Donnell* between selling stock and selling the underlying income-producing property remains in full effect and negates the "reserved income" theory as applied to a sale of stock for a price secured by income from the underlying business assets.

> Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the

[40]See also *Warren v. United States,* 171 F. Supp. 846 (Ct. Cl.), cert. denied, 361 U. S. 916 (1959); *Glenn E. Alexander,* 34 T. C. 758 (1960).

timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess a mere economic or pecuniary advantage derived from production. . . . *Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.* (Treas. Reg. §1.611-1(b)(1).) (Emphasis added).

Again, for purposes of Section 632,

> Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. (Treas. Reg. §1.632-1(a).)

(2) The requirement that the taxpayer must look *solely* to income from the reserved interest for return of his capital is not met because there was a retained lien on the assets of the former corporation, and because payments well in *excess* of buyer's after-tax income were guaranteed by the buyer if the income should prove subject to tax. The retained lien alone makes the case indistinguishable from *Anderson v. Helvering*, 310 U. S. 404 (1940). This case was virtually on all fours with *Thomas v. Perkins, supra,* with the one exception that in *Anderson* the seller received not only a cash down payment and an oil payment, but *also* a *lien* on the fee interests conveyed. This exception, however, made the difference between a *sale* and a reserved income interest. The Court said:

> The reservation of an interest in the fee, in addition to the interest in the oil production, however, materially affects the transaction. Oklahoma Com-

> pany is not dependent entirely upon the production of oil for the deferred payments; they may be derived from sales of the fee title to the land conveyed. . . . In the interests of a workable rule, Thomas v. Perkins must not be extended beyond the situation in which, as a matter of substance, without regard to formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas. The deferred payments reserved by Oklahoma Company, accordingly, must be treated as payments received upon a sale to petitioners, not as income derived from the consumption of its capital investment in the reserves through severance of oil and gas. (310 U. S. at 412-413.)

Petitioner apparently seeks to distinguish *Anderson* on the grounds that there was a 31% down payment (Br. p. 46, n. 25). This will not do, because there was an almost equally large (28%) down payment in cash and notes in *Thomas v. Perkins*, which did *not* make that transaction a sale. Moreover, the opinion in *Anderson* relied entirely on the reservation of the lien, and not the down payment, and in *Commissioner v. Southwest Exploration Co., supra*, this Court, 350 U. S. at 314, did not even refer to the down payment in restating the holding of *Anderson*. Furthermore, neither the Commissioner nor the lower courts have interpreted the holding as so limited.[41]

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[41] See G. C. M. 22730, 1941-1 C. B. 214; Treas. Reg. § 1.611-1(b)(1); *Hugh Hodges Drilling Co.*, 43 B. T. A. 1045, 1069-70 (1941); *Refiners Production Co.*, 43 B. T. A. 481, 493-94 (1941); *Charles Burke*, 5 T. C. 1167 (1945), *Acq.*, 1946-1 C. B. 1; *cf. Scofield v. LaGloria Oil & Gas Co.*, 268 F. 2d 699 (5th Cir. 1959), *cert. denied*, 361 U. S. 933 (1960).

In the present case, retention of a lien upon business assets appraised at 82% of the total purchase price [R. p. 32] cannot be ignored. The economic significance of this lien is that in the actual case, despite drastic declines in value as the property became worthless from an income-producing standpoint, the lien still eventually accounted for $262,096.49 of respondent's total $936,-131.85 proceeds of sale [R. p. 56]. If we are to apply the principles of the oil and gas cases, *Anderson,* as well as *O'Donnell,* only demonstrate further that the transaction was a sale.

CONCLUSION.

Petitioner requested a writ of certiorari in this case on the grounds that it was a tax case "of rare importance," (Pet. p. 7). He contends that it involves a purely tax-motivated transaction without economic significance (Pet. pp. 18, 33) and a grossly-excessive purchase price used to transmute ordinary income into capital gains (Pet. pp. 10, 33), and that it illustrates an area in which the lower courts had "unaccountably refused" to follow this Court's decisions (Pet. p. 16). On the above analysis, however, it is apparent that none of these representations are borne out by the facts, which negate the notion that the transaction was without economic significance. The realistic nature of the price demonstrates that respondents received no tax benefits to which they would not be entitled on any installment sale. The "unaccountable" unanimity of the lower Courts in holding such transactions to be sales turns out to be readily accounted for by all the prior opinions of this Court on facts such as this. In sum, the case turns out *on its facts* to present none of the issues which petitioner promised it would. It is in es-

sence a routine and inevitable determination that a particular transaction on particular facts constituted a sale of stock, under all rational principles and previously decided cases. Petitioner has chosen to elevate this case to such unusual importance, not because it in fact presents any undecided questions of law, for it does not, and not because there is any disagreement in the lower courts, for there is none. Rather, it is because, disappointed by the limited extent to which Congress this year responded to his request for ordinary income treatment on sales where full payment depends on earnings, the Commissioner now hopes this Court will do for him what Congress refused.

In this situation, we respectfully urge this Court to do what it did in a similar situation in *Rudolph v. United States*, 370 U. S. 269 (1962). The case should be dismissed because certiorari was improvidently granted.

In the alternative, if the Court determines to decide the case, the opinion of the Court of Appeals for the Ninth Circuit should be affirmed.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 63

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CLAY B. BROWN AND DOROTHY E. BROWN, DONALD L. BROWN AND INGRID R. BROWN, CHARLES WILLIAM BOOTH AND NANCY H. BOOTH, DONALD LEE BROWN, PHILLIP F. BROWN, MARILYN BROWN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

This brief is filed primarily in reply to the joint *amicus* brief filed on behalf of the University Hill Foundation and the taxpayers in four cases pending in the court below involving transactions between them and the University Hill Foundation similar to that involved in this case.

I

THE TRANSACTION MAKES NO MORE ECONOMIC SENSE WITH THE LIQUIDATION THAN WITHOUT IT

In our opening brief, in order to isolate the relevant part of the transaction for purposes of analysis, we assumed a simplified version of the transaction which omitted the liquidation and subsequent steps—to wit, a transfer of the stock to the Institute in exchange for notes under which the Institute's liability was limited to remitting 90% of any *dividends* received on the stock. The *amici* in effect concede that such a transaction would not be a "sale" for tax purposes:

> * * * the [transferor's] actions make no economic sense, would only occur for tax purposes and would necessarily involve a grossly excessive "purchase price" (any negotiations over which would be pure sham). Because the "purchase price" would grossly exceed fair value for the stock, the predominant nature of the * * * "sale" would be simply the retention of the "seller's" dividends on his stock for an extended term. A remainder interest would be gratuitously transferred to the "buyer" in the perhaps illusory hopes of obtaining more favored tax treatment on the retained dividends. * * * Were such a maneuver successful in producing capital gain, it might indeed involve * * * "extraordinary tax benefits" * * *. [pp. 9–10; see also 12–13]
>
> * * * [an] economically nonsensical proposition * * *, in which all possibility of gain on the upside would be sacrificed with no concomitant

> acceleration or downside cushion whatsoever. [p. 17]
>
> * * * where a "buyer" supplies no *quid pro quo* [as in the supposed case], he has nothing to bargain about, the rules of the market place will be inapplicable, and any resulting purported sale would merely be a gratuitous transfer of a remainder interest in stock in hopes of reducing the taxes on subsequent retained earnings. * * * [pp. 18–19]
>
> * * * the "sales price" will be paid only at the same rate as the income the "seller" would otherwise have earned, and the element of risk becomes infinite, because there is no cushioning whatsoever of the seller's downside risks to compensate for the sacrifice of possible appreciation on the upside. Therefore, there is no economic justification for less than an infinite amount of compensation for risk and futurity, and the transaction would occur at all only for tax purposes. * * * [p. 21, n. 9]

Having conceded our major premise—that such an economically meaningless transaction is not a sale[1]—the *amici* then devote over 30 pages of their brief (Br. 9–41) to a claim that the simplified version of the transaction is a "straw man" and that in the actual transaction, unlike the simplified version, the Institute *did* furnish a "substantial and meaningful *economic quid pro quo*" (Br. 13) and the transaction thus "made good economic sense to the sellers *without reference to their income taxes* and without an

[1] *Amici* never quite expressly concede the ultimate conclusion, but the quoted portions of their brief hardly leave the matter in doubt.

unreasonably high price" (Br. 10, emphasis added). The primary dispute between the *amici* and the government, then, is simply whether the actual transaction was or was not as "economically meaningless" as the simplified version analyzed in our main brief. We will show that it was.

In the simplified transaction, *A* transfers stock to *B* on *B's* promise to remit the dividends up to a stated amount (the purported "price"). The *amici* agree that such a transaction (and any "bargaining" over it) is economically meaningless because it gives *A* nothing that he did not already have. The actual transaction is wholly different, say the *amici,* because in it the Institute agreed, not merely to remit dividends, but to *liquidate* the corporation and to remit 90% of the earnings from the *assets,* an amount substantially greater (because of the elimination of the corporate income tax) than the respondents could have received as dividends had they kept the stock. The Institute's ability to "double" the earnings and thereby make accelerated payments to respondents gave the respondents a "cushion" to assure ultimate receipt of the purchase price and, by the same token, gave the Institute real bargaining power.

If the Institute did indeed have the magical power to make something of nothing, we would be hard pressed for a reply, for we basically agree with *amici* that a transferee's ability to increase the productivity of an asset (*e.g.,* by contributing services or managerial skills) may be enough in itself to make a transaction a "sale" (see Pet. Br. 62–65). Like most demonstrations of magic, however, the argument turns

out to be sleight-of-hand. The *amici* compare (1) what the Institute could realize (and remit to respondents) from liquidating the corporation and leasing its assets with (2) what the respondents could realize by not liquidating the corporation and receiving dividends. The only meaningful comparison, of course—if the purpose be to identify what the Institute contributed to the transaction—is with (3) what respondents could realize by themselves liquidating the corporation and leasing its assets. The "sale" and the liquidation were separable parts of the transaction, and if the liquidation is to be taken into account in appraising the results of the "sale," it must also be taken into account in appraising what the results would have been without the "sale." And if that comparison is made, it will be seen that the actual transaction is made up of the same straw as is the simplified version analyzed in our opening brief.

If respondents had themselves liquidated the corporation and "leased" the assets to Fortuna on the same terms as did the Institute, they would have received 100% of the amounts paid as "rent" by Fortuna. In the actual transaction—in which the stock was first "sold" to the Institute and the corporation was then liquidated—respondents were entitled to receive 90% of the amounts paid by Fortuna. The "substantial and meaningful *economic quid pro quo*" brought by the Institute to the transaction, then, was its agreement to remit to respondents 10% *less* than the amounts they would have received by engaging in the same transaction without its participation! Nor

did the Institute's purported[2] "guarantee"—that it would remit 90% of the rents whether or not it was required to pay a tax on them—add anything, for all that it "guaranteed" was an economic loss.[3]

In economic terms, therefore, the Institute's participation in the actual transaction, just as in the simplified version, could only result in a loss to the respondents; it was an "economically nonsensical proposition * * *, in which all possibility of gain on the upside [was] sacrificed with no concomitant acceleration or downside cushion whatsoever" (Am. Br. 17). Rather than making "good economic sense to the sellers *without reference to their income taxes*" (Am. Br. 10, emphasis added), it was only through the effect of the transaction on their personal taxes that respondents could hope to gain from the transaction. Without the Institute's participation, respondents could have had 100% of the "rents" paid by Fortuna and retained full ownership of the assets; with it, they got only 90% and in addition surrendered the ulti-

[2] The Tax Court found that respondents never "sought to find out about the Institute's financial condition at the time of the transaction" and that its resources in fact fluctuated from zero to $200,000 or $300,000, depending on the need for funds for cancer research (R. 47). Some of the other transactions in which the "guarantee" was allegedly of the essence involved "feeder" corporations capitalized at $1,000 (see Am. Br. 35).

[3] Had respondents themselves liquidated the corporation and leased the assets, not only would the amounts received by them have been greater (100% rather than 90% of the "rents") but they would have been received directly from Fortuna without being channeled through an intervening entity, thus eliminating entirely any risk of their being taxed first to someone else.

mate ownership of the assets; their only hope of gain was that, with the "rents" being channeled through the Institute and then being remitted to them as payments of a "purchase price", their lessened receipts would be taxable to them only as capital gains rather than as ordinary income, producing a *tax-saving* more than sufficient to compensate respondents for their substantial and undeniable *economic loss.*[4] There is no other explanation for the transaction and it, like the simplified version examined in our opening brief, was "economically nonsensical" and "would only occur for tax purposes" (Am. Br. 17, 9). The actual transaction was thus not a "sale" for precisely the same reasons that the *amici* concede the simplified version would not be.

II

THE TREATMENT OF THE TRANSACTION DOES NOT DEPEND UPON FINDINGS OF VALUE

The *amici* state our view as being "that a grossly-excessive purchase price is * * * the infallible touchstone by which the unreal, purely tax-motivated transaction can be spotted" and conclude that: "Thus in petitioner's view, the entire case hangs on the reasonableness of the purchase price" (Br. 26–27). The *amici* have misunderstood our position and put the cart before the horse. Our case begins and ends with the terms of the agreement itself. Since on the

[4] They equally hoped, of course, to avoid an immediate capital gains tax on the liquidation of the corporation, in which endeavor they have thus far been successful (see pp. 20–25, *infra*; Pet. Br. 75).

face of the agreement it is apparent that the Institute gave nothing in exchange for the property and made no commitment that could in any way lessen the risks borne by respondents, there was no sale. There being no "cushion" of any sort to assure payment, respondents' receipts were entirely dependent upon the income thereafter produced by the property, and their right to those receipts was neither more nor less than a retained right *to* that income. And whether the amount of income reserved by a transferor happens to be just equal to the value of the property transferred or is greatly in excess of it is ultimately irrelevant: in either case, what is received is income and must be taxed as such.

The irrelevance of findings of "value," moreover, cuts both ways: a "sale" is no less a sale because the price is excessive, and a right to income from property is no less a right to income because it is limited to an amount that happens to be equal to the value of the property. If *A* transfers stock to *B* in exchange for *B*'s personal note for $1500, a finding that the stock was actually worth only $1000 would establish only that *B* was gullible or badly informed, not that the transaction was not a "sale"; the note, backed by the personal liability of the solvent purchaser, gives *A* a right to payment independent of the income thereafter produced by the property and the burdens and benefits of ownership are shifted to *B*. If, on the other hand, *A* transferred the same stock to his son on his son's promise to remit the dividends up to a stated amount, *A*'s right to receive the dividends would still be but

a right to income whether the amount was $500, $1000, or $1500. It would be a right to income because, quite simply, *A* would have a right to nothing else.[5] The character of the transaction turns, in short, not upon how much the transferor may eventually receive from his interest, but upon the nature of the interest itself—whether it is a right wholly dependent upon, and thus a right to, future income or is, instead, a right to payment independent (at least to a significant degree) of the income produced.

Since questions of value are ultimately irrelevant, we need make only two brief comments on *amici's* extended argument about the findings in this and other cases (Br. 26–41).

First, the effort by *amici* to prove that the "buyer" in such transactions furnishes an "economic *quid pro quo*" by showing that several courts have found the "prices" not to be grossly excessive is absurd.[6] The

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[5] The only time the value of the stock would even arguably become relevant would be if (a) the amount of the dividends to be remitted was significantly *less* than the value of the stock and (b) *A* also had a right to "foreclose" on the stock if the amount was not received by a stated time (see Pet. Br. 36, 56). In this case, although respondents did have a foreclosure right, no claim is or could be made that the amount to be remitted was *less* than the value of the stock. The most that is claimed is that it was not "much" more than the value.

[6] Far more significant in showing the true character of the transactions are the few instances, involving equally arm's length transactions (indeed, with the same charity as in most of the other cases), in which the sellers failed to heed the advice of the tax commentators and set the "price" so high that, even with the wide latitude that exists in assigning a "reasonable" value to a closely-held business, the price was still found

terms of the transactions are established by undisputed documentary evidence showing precisely what each party contributes to the transaction (the "buyer," nothing) and what each gets out of it (the "seller," nothing, unless it be a hoped-for tax advantage); it is hardly necessary to reason backwards from findings of value to discover what those terms were. Inasmuch as *amici* agreed with us that only an "irrational seller" (Br. 40) would enter into such a transaction—*i.e.*, one as "economically meaningless" as the documents show these to be—at the same price at which he could otherwise sell the stock, what the numerous findings of "fair" or "reasonable" or "not grossly excessive" prices[7] prove is only that: (1) in view of the universally recognized difficulty of valuing closely-held businesses, there is inevitably a wide range of valuations that can be defended as abstractly "reasonable"; (2) that the "sellers" in such transactions were accurate in their estimate of how high the price could be set without being so flagrantly excessive as to jeopardize the desired tax treatment; (3) that *amici's* confidence in the valuation process to separate true "sales" from "economically meaningless" transactions (Br. 41) is misplaced.

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to be grossly excessive, a result that could not occur if the charity had real economic bargaining power. See *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cl.); *Brekke* v. *Commissioner*, 40 T.C. 789.

[7] We note that *on the terms of payment agreed on* the only truly "fair" and "reasonable" price would be an infinite one; in every case, the "price," far from being "grossly excessive," is in fact grossly inadequate.

Second, the Tax Court in this case did not find, as *amici* imply, that the amount of the rents to be remitted to respondent was no greater than the amount for which they could have sold the stock on normal commercial terms (*i.e.*, with the buyer making a significant commitment and assuming at least the primary risks)—which, in turn, is the only meaningful definition of "fair market value." Addressing itself specifically to that question, the court expressly acknowledged that "It may be" that respondents could not have sold the stock "at as favorable a price" in any other kind of transaction, but held that a taxpayer has a right "to increase the amount received" by his choice of transactions and that the fact that the charity in such transactions "is willing to pay a somewhat higher price than someone else might pay" did not prevent the transaction from being a "sale" (R. 62).[8] It was only to show—in response to an entirely different argument[9]—that the Institute acted at arm's length with a real (and reasonable) expectation that the rents would be sufficient to complete the payments, and that it would therefore ultimately receive the properties (see R. 36), that the court later observed that the "price" was "the result of real negotiating"

[8] The court of appeals similarly acknowledged that the amount to be remitted was "probably greater" than the market value of the stock (*i.e.*, the price obtainable on normal terms) (R. 295).

[9] *I.e.*, that the transaction was a "sham" in the sense that the pay-out was never expected to be completed and there was a "tacit understanding" that respondents could at any time precipitate a default and recover the properties (see R. 59, 62–63).

and "was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets" (R. 64). Rather than being inconsistent, what the latter comment shows is that there is indeed a wide "range" between what a closely-held business can actually be sold for on normal commercial terms and what can be defended as being "within a reasonable range in the light of * * * [etc.]"—the very fact that has made it possible for the nature of these transactions to be so successfully cloaked. Finally, if "market value" were relevant (which it is not) and if the Tax Court had found the amounts to be remitted to be no greater than the market value (which it did not), the findings would have to be reversed for internal inconsistency, however sufficient the formal evidence supporting each might be: as *amici* agree, only fools or benefactors give away something for nothing, and the Tax Court's findings that respondents were neither precludes a finding that they did.

III

IF THE LIQUIDATION WAS A "REALIZING EVENT," RESPONDENTS SHOULD HAVE PAID A CAPITAL-GAINS TAX IN THE YEAR OF THE LIQUIDATION, BUT THEIR SUBSEQUENT RECEIPTS WOULD STILL BE TAXABLE AS ORDINARY INCOME

To side-step the argument made in our opening brief, the *amici* would make everything in this case turn on the liquidation. They do not deny that if a transferor retains by contract a right to be paid the income produced by the very property transferred (as

in our "simplified version" of the transaction), the income thereafter remitted to him is ordinary income. The result is wholly different, however, say the *amici*, if the interest the transferor has after the transaction is a right to the income, not from the very same property, but from some substituted property. For in that event there is a "realizing event" (the conversion of an interest in one property into an interest in other property), and the existence of a "realizing event" somehow means—*amici* never say how—that any income thereafter received is taxable only as capital gain. In this case, the liquidation is said to have resulted in such a "realizing event": without the liquidation, respondents would have had a right to the income from the *stock;* with the liquidation, they had instead a right to the income from the *assets;* since the "exchange" of stock for a right to income from assets is a "realizing event", the income from the assets thereafter received is, by some form of alchemy, converted into capital gains. As we will show, *amici's* argument about the tax effect of the liquidation is fully as baseless as their argument about its economic effect (Point I, *supra*).

1. We have no reason to object to treating the liquidation as a "realizing event" and are quite willing to assume, for purposes of argument, that it was. For what is wrong with *amici's* argument is not the proposition they argue at such length (that the liquidation was a realizing event) but the proposition they assume *sub silentio:* that, if a right to income is received in a realizing transaction (rather than being merely retained in a non-realizing transaction), the

income thereafter received pursuant to that right is taxable only as capital gain. So novel and revolutionary is the proposition that it requires but a few examples to demonstrate its fallacy.

Suppose that *A* wishes to dispose of a house which he bought for $20,000 but which has appreciated in value to $30,000. If he sold the house for $30,000, he would have a capital gain of $10,000. Instead of selling it, however, he transfers it to *B* in exchange for an assignment of one-half of *B*'s life estate in a trust, an interest which at the time is worth $30,000. Thereafter during the course of *B*'s life, *A* receives income distributions from the trust totaling $100,000. The exchange of the house for the trust interest was undeniably a "realizing event." Does it follow that the entire $100,000 received from the trust is gain from the "sale" of the house, taxable only as capital gain? The answer, of course, is no.

As *amici* agree, the purpose of the capital-gains provisions was to lessen the tax burden on the realization in a single year of the "accumulated increments of value over the prior years" (Br. 45), the "previously accrued but hitherto unrealized gains of prior years" (Br. 46), or the "appreciation enjoyed by [the asset] over the years [the taxpayer] owned it up to the time of final disposition" (Br. 67). See also Pet. Br. 59–61. They were not intended to shield from the regular tax the future income from the interest received in an exchange. And the only way that the accrued gains can be separated from the future income is by *valuing* the interest received in the exchange and using its value as the dividing line: the excess of

the value of the interest received over the basis of the asset exchanged is taxed as capital gain; the taxed value becomes the basis of the interest received; and the income thereafter produced by that interest is taxed according to its own nature, with whatever allowances for basis recovery are appropriate (*e.g.*, depreciation or amortization). In effect, the transferor is treated as though he had sold the asset for an equivalent amount of money and then purchased the acquired interest with the proceeds.

In the case supposed, the "amount realized" from the "sale or exchange" of the house would be $30,000, the *value* of the trust interest, producing a capital gain on the disposition of the house of $10,000. *A* would then have a basis of $30,000 in the trust interest which, since that interest is a wasting asset, could be amortized against the $100,000 of income thereafter received, leaving net ordinary income of $70,000. In short, *A*'s total gain of $80,000 over the entire period would be divided between $10,000 of capital gain and $70,000 of ordinary income, the obviously correct result.

The point—so rudimentary that it would not require stating but for *amici's* obscuring it—is that, if in a "realizing event" a transferor receives a right to income in exchange for a capital asset, the only "amount realized" "from" the exchange itself (and hence the only amount taxable as capital gain) is the *value* of the right to income; the income thereafter produced by that right remains fully taxable as ordinary income. Capital gain is "gain from the sale or

exchange of a capital asset" (§ 1222(3)); the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis" (§ 1001(a)); and the "amount realized from the sale or other disposition of property shall be the sum of any money received plus *the fair market value of the property (other than money) received*" (§ 1001(b)). Since a right to future income is "property (other than money)", it is only the "fair market value" of the right received that enters into the computation of capital gain.

Nor is it any more relevant to the treatment of a "received" interest than it is to the treatment of a "retained" interest whether, in property-law concepts, the right to the income is viewed as a property interest in the underlying asset or as merely a "contract right" to be paid the income from it (see Pet. Br. 41). For tax purposes (and, indeed, for State-law purposes), a "contract right" is as much "property" as is an interest in tangibles, and whichever form the "property" received in the exchange is in, it is only its "fair market value" that constitutes the "amount realized" from the exchange. Thus, in the above example, it would make no difference if, instead of "assigning" a half-interest in his life estate, *B* simply "covenanted" to remit to *A* one-half of all the distributions he received from the trust and pledged the trust interest only as "security" for the promise. Were such a mere change of form successful in converting the entire $100,000 thereafter received by *A* from the trust income into "capital" receipts from the "sale" of his $30,000 house, it is not

hard to see that the distinction between ordinary income and capital gain would be short-lived.

To take another example involving a liquidation as the "realizing event," suppose that a corporation owned equally by *A* and *B* constructs a building on leased land and then leases the building to a department store for the full remaining term of the ground lease. When the lease still has 20 years to run and when the value of the leasehold is just equal to the stockholders' basis in their stock (so no capital-gains tax need be paid), *A* and *B* decide to liquidate the corporation in order to eliminate the corporation income tax and to be able to take depreciation on the leasehold themselves. If they did no more than that, *A* would receive on liquidation a half interest in the leasehold with a basis just equal to his basis in the stock (there being no gain); he would be entitled to amortize the basis against the rents thereafter received, and the balance would be taxable as ordinary income.

Instead of doing that, however, *A* (perhaps having read *amici's* brief) transfers his stock to *B* on *B's* "personal covenant" to liquidate the corporation and thereafter to remit to *A* one-half of the rents received for the life of the leasehold, the promise being "secured" by a mortgage on the building and an assignment of the rents.[10] Since the liquidation results in

[10] The same thing could be accomplished, of course, by *B* giving *A* a "promissory note" in an amount equal to one-half of the total rents to be paid over the remaining leasehold term but limiting his personal liability to an obligation to remit one-half of the rents actually received.

a conversion of *A*'s stock interest into something "different," there is no doubt a "realizing event." Does it follow that *A* is entitled to report all of the rents remitted to him for the next 20 years (in excess of his basis for the stock) only as capital gain—*i.e.*, as "amounts realized" from the "sale" of his stock? Once again, the answer obviously is no. The "property" received in exchange for the stock was, not the rents themselves, but the contract right to receive them, and it is only the "fair market value" of that right that enters into the computation of capital gain or loss. That right being worth no more than *A*'s basis for the stock, there is no capital gain at all. The rents thereafter remitted to *A* are but the return on his still unrecovered investment and are fully taxable as ordinary income (subject only to amortization deductions for his basis in the wasting asset).[11]

[11] In the case supposed, there would be no doubt of *A*'s right to amortize his full basis against the rents received, since the underlying property—the leasehold—was itself a wasting asset (see § 167). In this case, however, there is a serious question whether respondents were entitled to amortize their full basis. A term interest in property is itself, of course, normally a wasting asset even though the underlying property (*e.g.*, land or stock) is not. But when the limitation on the term is created by a *gift* of a remainder interest, no amortization is permissible. If, for example, a father gives his son a remainder interest in stock, reserving the right to the income for life, he cannot allocate a part of his basis to the reserved life estate and then depreciate or amortize that part of the basis on the ground that the life estate is a wasting interest; rather, the donor's entire basis "shifts" to the donee as the remainder matures, so that the son will end up with his father's full basis. The same thing is true of a life tenant and remainderman receiving their interests from a common donor. See Income Tax Regs.

In short, the *amici's* entire argument is based on the fallacious premise that, if a contract right to receive future payments of money is received in a "realizing event," the future payments when received are taxable only as capital gain notwithstanding that the right to receive them was itself a right *to income*. To the contrary, as we have shown, if the right held by the transferor after the transfer is a right to income, the income when received must be taxed as such and it matters not at all, for that purpose, whether the right was one "retained" in a non-realizing transaction or one "received" in a realizing transaction. As shown in our opening brief, in turn, respondents' right to receive 90% of the income from the assets up to $1,300,000 (plus a right to recover the property if that amount was not received by a stated time), having been in no way underwritten by the Institute and being wholly dependent on the future income, was neither more nor less than a right to the income from the property. That being so, the income thereafter remitted to them was taxable as ordinary income, whether or not the original transaction was a "realizing event." The only significance of the question whether there was a taxable event in 1953, as we will

(1954 Code) §§ 1.1014–5, 1.1015–1(b). In this case, since the limitation of the respondents' interest to a temporal interest in the business was the result simply of a gift of the residual interest to the Institute, it would seem that they were *not* entitled to amortize their basis except to the extent that it was attributable to depreciable underlying assets. Since the Commissioner did in fact allow respondents to offset their full basis in the stock against the payments, however, the question is not presented here.

now show, is whether respondents should not have paid a capital-gains tax in 1953 *in addition* to an ordinary-income tax on the remitted rents.

2. If the respondents had themselves liquidated the corporation in 1953 and then leased its assets to Fortuna, they would admittedly have had to pay (1) a capital-gains tax in 1953 measured by the excess of the value of the assets over their basis for the stock (§ 331) *plus* (2) an ordinary-income tax on the rents thereafter received from Fortuna (less depreciation on any depreciable assets based on the value at which they were taxed on the liquidation).[12] The same result would follow if respondents had themselves liquidated the corporation and then transferred the *assets* to the Institute on terms otherwise the same as those of the actual transaction.[13]. The question is whether the fact that the stock, in form at least, was transferred to the Institute *before* the liquidation "insulated" respondents from taxability on the liquidation and, if

[12] We are assuming, for purposes of this discussion, that the liquidation of the corporation and the purported "lease" of its assets to Fortuna did not constitute a "reorganization" and, further, that the "lease" is to be treated as a true lease rather than as an "equity" or "stock" interest in Fortuna. Should the issue become important on remand of the case—it is not relevant to the issue before this Court—we would argue to the contrary (see Pet. Br. 73–75).

[13] In that event, we take it that even *amici* would agree that the transfer to the Institute would not be a "sale." With the liquidation already having taken place, it could hardly be the "*quid pro quo*" furnished by the Institute (see Point I, *supra*), and since the "rents" would come from the very property transferred (*i.e.*, assets, not stock), the right to them would be but a "retained" interest in the property, not a different interest received in "exchange" for it.

not, how their gain should be measured. There are three possibilities to be noted.

a. Under the so-called "step transaction" doctrine, as *amici* note (Br. 59–60), the ordering of the several steps of an integrated transaction is not necessarily determinative of the tax consequences, and the tax treatment is to be determined according to the true nature of the transaction considered as a whole.[14] Apparently not appreciating the implications of the argument, *amici* cite Rev. Rul. 60–370, 1960–2 Cum. Bull. 203,[15] as a proper application of that principle to a transaction like this one and thus as establishing that the liquidation here was a taxable event to respondents (Br. 56). In that ruling, appreciated securities were conveyed to a university subject to a requirement that the university sell the securities, reinvest the proceeds in tax-exempt bonds, and pay the income from the bonds to the transferor for his life. The ruling held that, since the university was required to convert the appreciated securities into other property, "in substance, the transferor did not give the trustee appreciated property to hold in trust, but, rather, gave the trustee the proceeds of the sale or exchange of the property which the trustee was required to consummate" (p. 205), and, accordingly, that the transferor was taxable on the gain realized on the sale of the securities.

[14] *Gregory* v. *Helvering*, 293 U.S. 465, 469–470; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613; *Bazley* v. *Commissioner*, 331 U.S. 737, 741–743; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, 334; *Georgia-Pacific Corp.* v. *United States*, 264 F. 2d 161, 162–163 (C.A. 5); *United States* v. *General Geophysical Co.*, 296 F. 2d 86 (C.A. 5), certiorari denied, 369 U.S. 849.

[15] But cf. Rev. Rul. 55–275, 1955–1 Cum. Bull. 295.

Amici make a strong case that there is "no tenable distinction" between the transaction involved in the ruling and that involved in this case (Br. 56). We are inclined to agree, and if the ruling is sound, what it means is that, since the terms of the agreement specifically required the Institute immediately to liquidate the corporation—the several steps were, indeed, all consummated on the same day—respondents should be treated as having themselves liquidated the corporation and as having in substance transferred only the assets (not the stock) to the Institute. What *amici* unaccountably fail to note, however, is what the tax consequences of that treatment would be: respondents would have to pay a capital-gains tax in 1953 measured by the full value of the corporate assets and *in addition* pay an ordinary-income tax on all the "rents" thereafter received from their "retained" interest in the assets [16]—which was, in fact, precisely the treatment accorded the transaction in Rev. Rul. 60–370, *supra*. It is small wonder that respondents do not share *amici's* enthusiasm for treating the liquidation as a "realizing event" but rather expressly disavow (as we predicted they would, see Pet. Br. 75) any "contention that liquidation has independent capital gain significance" (Resp. Br. 36–37).

b. A second alternative—which gives partial effect to the form of the transaction but still produces a taxable event—would be to treat the gift to the Institute of a residual interest in the *stock* as an event of inde-

[16] As noted above, they would of course have a basis for depreciation of the depreciable assets increased to the value at which they were taxed on the liquidation.

pendent significance taking place before the liquidation and then treat the liquidation as resulting in a taxable conversion of the respondents' retained income interest in the stock into an income interest in the assets.[17] The liquidation would be treated as resulting in a taxable "sale or exchange" to the respondents, but the "amount realized" from it would be, not the full value of the assets, but only the value of the interest in them which respondents ended up with (*i.e.*, the right to 90% of the income from them up to $1,300,000 plus contingent rights of recovery). That value would be equal basically to 90% of the value of the assets, with some appropriate deduction for the conditional residual interest given to the Institute. Apart from that slight difference in the measure of the gain, however, the tax consequences would be substantially the same as under the first alternative: respondents would be taxable *both* on the original transaction (capital gain, measured by the value of the *right* to income received in the exchange) and on the rents thereafter received (ordinary income, les-

[17] We note the possibility only for the sake of completeness. In fact, it seems to us to have little to commend it and to produce an anomalous difference in result between economically identical transactions and give to the form of the transaction a significance inconsistent with the step-transaction doctrine. In fact, as Rev. Rul. 60–370 recognized in identical circumstances, the Institute never received a beneficial interest in the stock itself since it was required under the very terms of the grant immediately to liquidate the corporation; in substance, all it ever received was an interest in the assets themselves—a current right to 10% of the income from them plus the right to full beneficial ownership upon the expiration of the respondents' retained interest.

sened somewhat by the stepped-up basis for depreciation).[18]

c. By giving full effect to the form of the transaction, it is possible to argue, as a final possibility, that the liquidation was not taxable to respondents at all. They had previously transferred their stock to the Institute, and in form it was the Institute, not respondents, who liquidated the corporation. To the Institute, the liquidation was a tax-free transaction, not only because it was an exempt charity, but because it was itself a corporation and the Code provides expressly for non-recognition of gain or loss on a parent's liquidation of a subsidiary (§ 332). Since the transformation of the stock into assets was a tax-free transaction, the transformation of respondents' retained interest in the stock into an interest in the assets should likewise be treated as a nontaxable transaction; respondents' interest would thus still be a "retained" rather than an "acquired" interest, albeit in property held in a new form of ownership as a result of a tax-free transaction. Were that the proper treatment, respondents would not have been subject

[18] Were the 1953 gain to be measured by the value of the *limited* income right retained (or received) by respondents, rather than by the full value of the assets, it might on the surface seem to enhance their right to write off the full amount of their basis (the taxed value) against the subsequent receipts, rather than being allowed to take depreciation only on the depreciable assets. Regardless of which way the transaction is taxed, however, the limitation of respondents' rights to a temporal interest was the result solely of a *gift* of the residual interest to the Institute, and, as noted previously (note 11, *supra*), a taxpayer cannot convert a nonwasting asset into a depreciable one by making a gift of a remainder interest.

to a capital-gains tax on the original transaction, but they would, of course, be fully taxable on the rents thereafter received by them under their "retained" right to income.

We have shown that under each of the possible ways of treating the liquidation, the subsequent proceeds of respondents' right to receive 90% of the income from the assets would still be taxable as ordinary income. Whether, as a result of the liquidation, there was (as *amici* contend) a "realizing event" in 1953 is a question relevant only to (1) whether respondents should *also* have paid a capital-gains tax in 1953 and (2) whether, as a consequence, they are entitled to a stepped-up basis for depreciation of the depreciable assets. Since the Commissioner did not assert a tax on the liquidation, it is too late now for the government to raise the question. Respondents, on the other hand, could now claim a stepped-up basis as a result of the liquidation only by exposing themselves to a further deficiency for 1953 (see §§ 1311–1314), which they are understandably unwilling to do (see Resp. Br. 36–37). And the *amici* obviously have no standing themselves to raise the question. Accordingly, the question is not before the Court and need not be decided.

3. While some lower court decisions have made *amici's* mistake of assuming without discussion that, so long as there is a "realizing event," the proceeds of any "contract right" to future payments are necessarily taxable only as capital gain notwithstanding that the right is itself a right to income, none of the decisions of this Court cited by *amici* in any way

support the proposition. In *LeTulle* v. *Scofield*, 308 U.S. 415 (Am. Br. 49, 63), which is irrelevant in any event,[19] only the *value* of the interest received was treated as the "amount realized" in the exchange. *Helvering* v. *O'Donnell*, 303 U.S. 370 (Am. Br. 59, 63, 76–77), involved only a depletion question and was decided on concepts peculiar to that question—which, moreover, have since been rejected even for depletion purposes.[20] *Arrowsmith* v. *Commissioner*,

[19] *LeTulle* held only that the transfer of the assets of one corporation to another in exchange for cash and bonds was not a "reorganization" since the bonds did not satisfy the "continuity of interest" requirement. No claim was made that the bonds actually represented an "equity" rather than a "debt" interest, and in any event it may well be that "continuity of interest" requires an interest that is "equity" in form as well as in fact. Nor were the facts at all similar. The transferee not only made a substantial payment in cash but, in contrast to the Institute's purely passive role, was to operate the properties itself. As to the adequacy of its capitalization, all that appears is the statement of the court of appeals that the transferee "apparently had little capital, and found difficulty in" paying all cash for the property (103 F. 2d 20, 21), which is far removed from a finding that the transferee made no substantial investment in the enterprise (either of money or services) and thus did not relieve the transferor even of the primary risks.

[20] *Amici* to the contrary notwithstanding, all *O'Donnell* held was (1) that "ownership" of the "oil and gas in place" was prerequisite to depletion; and (2) that a "personal covenant" to pay a share of the "net profits" derived from production did not create such an interest. The distinction between a "personal covenant" and "an interest in the properties themselves" drawn in that case (303 U.S. at 372) has not survived even for depletion purposes (see Pet. Br. 47, n. 26). In any event, since a "personal covenant" is *itself* "property" within the meaning of the capital gains provisions (§ 1001(b)), whether it results in an "ownership" interest in some underlying prop-

344 U.S. 6, involved nothing resembling a right to income from property and for what it is cited (Am. Br. 59) is not apparent.[21] That leaves for discussion only *Burnet* v. *Logan*, 283 U.S. 404 (Am. Br. 45, 59, 63), a case so frequently mis-cited that a full analysis seems appropriate.

Burnet v. *Logan* involved a transaction occurring in 1916, well before special treatment was first accorded capital gains (in 1921). The case was concerned, therefore, not at all with the character of the gain as ordinary income or capital gain, but only with the proper time of accounting for certain receipts by a cash-basis taxpayer. The stockholders of a steel company which owned rights to 12% of the production of an iron-ore mine transferred all their stock to another steel company in exchange for $2,200,000 plus the company's agreement to pay them 60 cents for each ton of ore it received under the acquired rights. The question was whether the stockholders had to account immediately not only for the cash payments but also for the value of their contract right to receive the per-ton payments. The Court held that since the promised payments were "wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty," the "promise was in no proper sense equivalent to cash"

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perty could be relevant, if at all, only for depletion purposes. In *O'Donnell* itself, moreover, the net profits received had in fact been reported as ordinary income, and there is not the slightest suggestion in the opinion that they could have been anything else.

[21] *Arrowsmith* holds, in effect, that a repayment of an amount previously reported as capital gain should be accounted for as a capital loss in the year of repayment.

and "had no ascertainable fair market value" (p. 413). Accordingly, it held that the stockholders could apply the payments received first against their basis for the stock and report as income only the payments received after their basis was first recovered. The Court emphasized that, while it had been "necessary" to value the contract rights for estate tax purposes (as to one of the stockholders who had died), the stockholders' "liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation" and that the "situation" did not "demand that an effort be made to place according to the best available data some approximate value upon the contract" (p. 412).

The implications of that decision for capital-gains purposes are unclear. The Court recognized that *in principle* the contract should have been valued and its value treated as the amount realized for the stock; it declined to require that treatment only because it considered the value too speculative to be readily ascertainable *and* because, in the circumstances, there was no necessity to do so—apart from timing, it made no difference which way the transaction was accounted for and the proper ultimate tax liability could be more "fairly determined" by abiding the event. With the later addition of the capital-gains provisions, however, it has in many circumstances become just as "necessary" to value contract rights for income tax purposes as it was then for estate tax purposes: if the contract right was received in exchange for a capital asset (so that its value ought to be taxed as capital gain) but the right itself is an "income" interest the annual proceeds from which are in their nature

ordinary income (and ought to be taxed as such), the *ultimate* tax liability cannot be "fairly determined" without valuing the right as best it can be valued. Much more turns on the assignment of a value to the right than merely a matter of timing, as in *Burnet* v. *Logan*, and thus the "situation" does "demand that an effort be made to place according to the best available data some approximate value upon the contract."

If a contract right to income is not valued for capital-gains purposes, the only solutions are either (1) to tax all of the proceeds as ordinary income because the interest producing them is an "income" interest (thus ignoring the fact that the proceeds represent in part a realization upon the value of the capital asset given in exchange for the interest) or (2) to tax all the proceeds as capital gain because the interest was received in exchange for a capital asset (thus ignoring the fact that the proceeds represent in part ordinary income earned by the interest after its acquisition). Either solution—and nothing in *Burnet* v. *Logan*, by the way, gives more support to one than to the other [22]—produces a wholly distorted tax liability, not merely in the time of payment but in the liability as "ultimately" determined. However, rough it may be, an approximation of the "value" of the right [23] will

[22] See *Ware* v. *Commissioner*, 159 F. 2d 542 (C.A. 5); cf. Rev. Rul. 239, 1953—2 Cum. Bull. 53, making an allocation of the payments as received.

[23] In many cases, the problem of valuation can be solved by presuming the value of the interest received to be equal to the value of the asset exchanged. See *United States* v. *Davis*, 370 U.S. 65, 71–73. If a house is exchanged for a right to 5% of the sales of a business for a term of years, it may be difficult to value the right received but there should be no difficulty in valuing the house.

surely produce a more "fairly determined" ultimate tax liability than either of the alternatives and, if so, there is nothing in *Burnet* v. *Logan* that stands in the way of making such an approximation. At the very least, any contrary doctrine, being a doctrine of necessity admittedly producing the wrong ultimate tax liability, can justifiably be invoked only upon a showing of the most compelling necessity.[24] In short, as put by the regulations, it is "only in rare and extraordinary cases" that property can be considered to have no ascertainable market value (Income Tax Regs. (1954 Code) § 1.1001–1(a)).

The valuation of a closely-held going business (or of an interest in it) is, to be sure, a difficult matter, and we readily acknowledge that the answer given can never be more than an approximation. Yet it is the kind of valuation that courts are frequently called upon to make, and there has been no showing that any of the possibly relevant interests in the business in this case is so uniquely difficult to value that this qualifies as one of those "rare and extraordinary cases" in which, notwithstanding the resulting distortion of income, it is impossible to assign any value

[24] Query, if the interest received in exchange for a capital asset is of such wholly uncertain value that its value cannot even be approximated, wouldn't the sounder result then be to treat the event as not being a "realizing event" at all, transfer the basis of the exchanged asset to the interest received, and then account for the proceeds from that interest according to their own nature? That is the treatment universally accorded to transactions which qualify for "nonrecognition" of gain or loss under specific statutory exceptions; why a non-statutory exception should receive wholly different treatment is not apparent. See §§ 358, 362, 1031–1037.

at all to the interest. The *amici,* indeed, having cited *Burnet* v. *Logan* for a far more sweeping proposition, ha e not even argued that it is.[25]

1 sum, neither on authority nor on reason can the pa ments received under a contract right be treated as an "amount realized" from the transaction in which the right was acquired (or retained) if the right was itself but a right to future income. If, on the other hand, the right is a secured right to receive specified amounts in the future regardless of the income from the property—*i.e.,* an independent "debt" obligation—the payments when received represent simply a realization upon the value of the asset at the time of the exchange, not a distribution of later income, and it is therefore proper to treat them as "amounts realized" from the original transaction itself. The only issue in the case, then, to which

[25] If the liquidation did give rise to a "realizing event," moreover, the proper treatment, as shown above (pp. 20–23), would be to tax respondents on the full value of the assets, treating them as though they had themselves liquidated the corporation and then transferred the *assets* to the Institute, thus "retaining" rather than "receiving" the contract right to income. On that treatment, the only thing that would need to be valued would be the assets themselves, not the "contract right." And even if it were necessary to value the contract right itself, no great difficulty would be encountered: as a right to 90% of the income from the assets, its value would basically be equal to 90% of the value of the assets. If, because of its remoteness and uncertainty, the Institute's residual interest in that share of the assets could not readily be valued (to arrive at a proper "discount"), surely the more reasonable thing to do would be to ignore that minor limitation rather than conclude that, because of it, no value at all could be assigned to respondents' rights.

amici never address themselves, is how the distinction between a "debt" obligation and an "income" right is to be made. As shown in our opening brief, while full certainty of payment is not necessary to qualify the right as a "debt" interest, the transferee must at a minimum make some kind of commitment which results in a shifting of at least the primary risks and gives the transferor a "cushion" to assure payment. If, as here, the transferee furnishes nothing, and the transferor's rights to payment are entirely dependent upon the future income from the property, what he receives is not a payment of a "debt" arising from the "sale" of the property but simply the proceeds of a continued right to income. Whether the distinction be stated in terms of defining a "sale" for purposes of installment-sale treatment (the way it was framed in our opening brief) or in terms of defining the "amount realized" from a sale or exchange, the distinction is the same.

IV

THIS CASE INVOLVES NOT A NOVEL DOCTRINE, BUT THE PRESERVATION OF FUNDAMENTAL PRINCIPLES OF CAPITAL-GAINS TAXATION

Amici's claim that our argument is "novel" and "revolutionary" is wholly unfounded. It is no more "novel" than is the distinction between a right to income and a "debt"; it is no more "revolutionary" than the proposition that capital gain is limited to the appreciation in the value of property up to the time of its disposition and does not include income later

earned from the interest received in exchange for it. The only things revolutionary about this case are the implications of the lower courts' (and *amici's*) disregard of those fundamental propositions, a disregard which would obliterate the distinction between ordinary income and capital gain.

1. In purporting to assess the impact of our argument, *amici* mistake what this case is about and what the scope of our argument is. What is involved here, and all that is involved, is a transaction in which the transferee of income-producing property furnishes nothing in exchange for it, contributes nothing to the production of the income, and undertakes merely to remit to the transferor part of whatever income is independently produced by the property. All that we contend, and all the Court need decide, is that the transferor's right to the future payments in such a transaction—being entirely dependent on the income from property enhanced neither in value nor productivity by the transferee—is but a right to the future income and must be taxed as such. Any transaction in which the transferee does make a significant commitment of some sort—whether it be in the form of a down payment or a pledge of assets or personal liability or of a contribution of services or investment to make the property more productive—poses an entirely different question, and in most such cases we do not question that the subsequent payments should properly be treated as "amounts realized" from the original transaction itself rather than from a continuing participating interest in income.

The failure of *amici* to understand the very limited scope of our argument is evident from the "single example" they offer to "illustrate" its impact: a sale of land to a developer and the developer's sale of homes to purchasers, in each case with little or no down payment and without personal liability (Br. 68–69). The transactions are wholly different from that involved here and nothing in our argument would jeopardize their treatment as sales. The developer who buys land for development makes a very substantial investment both of services and of money in developing the property, thereby enhancing the security for the land mortgagee and placing on himself at least the primary risks of the enterprise. The purchaser of a home, in turn, must ultimately pay for it out of his own pocket; even if he makes no down payment, he must begin making payments on the mortgage immediately and must continue them if he is not to lose his investment. Neither transaction bears any resemblance to a transfer of income-producing property on the transferee's undertaking merely to remit the income produced by it with no contribution by him.

Amici pretend to see a host of unique problems that would be presented in accounting for such transactions if they are not treated as deferred-payment "sales" (Br. 67–68). But even *amici* concede that there are some such transactions (*i.e.*, where the "price" is "grossly excessive") that are not entitled to sale treatment, and the problems of determining the proper alternative treatment are no different in the two situations. If respondents, instead of purporting

to "sell" the stock to the Institute, had made a "deed of gift" of the stock to the Institute on condition that it liquidate the corporation and remit to them the first, say, $2,000,000 of income from the assets, we take it not even *amici* would assert that the remittances should be accounted for as capital gain. And whatever would be the proper treatment of that transaction is equally the proper treatment of this transaction, for it was likewise neither more nor less than a gift with a reserved right to income. The question is not whether such a category of transactions exists—or how they are properly treated—but simply whether this transaction belongs to that category.

2. The truly sweeping implications of this case are to be found not in our position, but in *amici's*. Their argument, as we have shown, is that whenever, in a "realizing transaction," a taxpayer disposes of a capital asset and receives a contract right to future payments, the payments when received must be treated as "amounts realized" from the "sale" of the asset, notwithstanding that the payments may be wholly dependent upon (or, indeed, measured by) income and notwithstanding that the total amounts received may bear no relationship (or only a fortuitous one) to the value of the asset exchanged.[26] In short, in *amici's* view, all that is required to convert future ordinary income into capital gain is (1) to create a "realizing event" and (2) to transform the income in-

[26] See, *e.g.*, Am. Br. 60: "a sale is simply a realizing transaction in which an asset is transferred to another party in exchange for cash or a right to cash * * *."

terest from a "property" interest in the income-producing asset itself into a "contract right" to be paid the income from it. So simple are those two steps to accomplish that the income from virtually any property could readily be converted into capital gain. A few examples should serve to demonstrate the point:

(1) *A* transfers General Motors stock to a charity on the charity's agreement to sell the General Motors stock, reinvest in Ford stock, and remit to *A* all the dividends received on the Ford stock during his lifetime. There is a realizing event (the disposition of the General Motors stock), and *A* receives only a right to future payments of money; hence all the dividends thereafter remitted to *A* during his lifetime are capital gain. Some variant of that transaction, it may be seen, could readily be employed by virtually any taxpayer in the country wishing to convert future income into capital gain.

(2) With fully depreciable property, it is unnecessary to use a charity: *A*, through a corporation, constructs a building on leased land and lets it for the entire remaining term of the ground lease—say, 30 years—at an annual net rent of $21,000. He then transfers the stock to *B* on *B's* agreement to liquidate the corporation and to remit to *A* $20,000 out of the rents received each year for the entire 30-year term. There is a realizing event (the liquidation) and *A* receives only a right to future payments of money; hence the entire $600,000 he receives over the 30-year term will be taxable only as capital gain. *B* will have to include the $21,000 annual rents in his income, but his "cost" basis of $600,000 in the

leasehold entitles him to an annual amortization deduction of $20,000, leaving him taxable only on $1,000, the amount that he keeps.

(3) With neither depreciable property nor the use of a charity, ordinary income cannot be avoided entirely but it can at least be shifted to a lower-bracket taxpayer: *A* first incorporates the property and then transfers the stock to his son on his son's agreement to liquidate the corporation and to remit the income from the property to *A* for a time or up to a stated amount. If the amount of income to be remitted to *A* is no greater than his basis in the stock, he will not have to pay even a capital-gains tax, and the income from the property will be taxable only in the son's lower bracket.

The examples could be multiplied, but those should be enough to reveal the sweeping implications of *amici's* argument. It is not an overstatement to say that, if *amici's* standard were adopted, it would virtually destroy the distinction between ordinary income and capital gains. As we have repeatedly emphasized—and as *amici* do not deny—the only thing entitled to capital-gains treatment is the appreciation in value of a capital asset prior to its disposition. When what is received in exchange for a capital asset is itself a right to income, the only possible way in which the capital gain can be separated from the future income is by valuing the *right* to the future payments and treating its *value* as the "amount realized." Only when the future payments are in payment of an independent "debt" incurred at the time of the sale do they represent a realization simply

on the value of the asset sold, and only then may they properly be treated as an "amount realized" from the sale itself. In treating all rights to future payments of money as of one category—without distinguishing between rights to income and rights to payment of a "debt"—*amici* would subvert the most fundamental principles of capital-gains taxation.

Respectfully submitted,

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FEBRUARY 1965.

U.S. GOVERNMENT PRINTING OFFICE: 1965